WATERSHED OVERVIEW

how do you see the world...

...we build managed accounts

FUNDS MANAGEMENT

WATERSHED

FUNDS MANAGEMENT

Watershed Funds Management

Watershed Funds Management is a specialist Managed Account provider and has been a pioneer in the delivery of MDA & Managed Account (SMA) solutions to financial advisers. Watershed leverages the expertise of a highly credentialed investment team to form a global thematic view that determines asset class and sector allocations.

Our investment committee structure differs for each Managed Account (SMA) and is chaired by an individual with niche expertise and a proven track record for managing portfolios within that asset class. With a research process that is both rigorous and thorough we have been able to deliver strong historical returns across our full suite of SMA's.

An investment in a Watershed SMA provides professional and active investment management with full transparency of holdings, transactions and structure. Watershed seeks to form a collaborative relationship with advisers, actively communicating portfolio strategy in the current market environment so that advisers are better equipped to communicate with their clients.

Disclaimer

This document is for the intended recipient only and is provided on the condition that you keep it confidential and do not copy or circulate it in whole or in part.

No part of this document may be reproduced without the permission of Watershed Funds Management Pty Ltd. Copyright in this document is owned by Watershed Funds Management Pty Ltd.

This information has been provided for use by Business and Professional Investors only and is not for distribution to the general public.

This presentation provides general information only and does not take into account the investment objectives, financial circumstances or needs of any person. To the maximum extent permitted by law, Watershed Funds Management Pty Ltd, its director and employees accept no liability for any loss or damage incurred as a result of any action taken or not taken on the basis of the information contained in the report or any omissions or errors within it. Before making an investment decision you should consider the latest Product Disclosure Statement or Financial Services Guide and assess whether the product and / or services is appropriate for you. It is advisable that you obtain professional independent financial, legal and taxation advice before making any financial investment decision. Watershed Funds Management does not guarantee the repayment of capital, the payment of income, or the performance of its investments. Performance of the Watershed Funds Management SMA's is based on theoretical portfolio tracking of the model portfolio and is gross of investment management & administration fees, but net of transaction costs. Quoted performance is annualised for periods of 1 year or greater.

QUARTERLY MARKET UPDATE

- Borrowing from the future!

PROCESS

- Part 1: Macro Environment: Central Banks (monetary) and Government (fiscal)
- Part 2: Underlying Economic Environment and outlook
- Part 3: Market (asset class) Valuation and outlook

CB AND GOVT ACTIVITY: STIMULUS, AS GOOD AS IT GETS?

- After Unprecedented easing (fiscal and monetary) - will this year see a tightening of conditions? (which could just be *less* easing). China has already started. This will be the main driver of markets over the short to medium term (1-3 years).
- Because of the above; the world is awash with cash – which has been the real driver of financial markets (more and more money created chasing assets) – what will change this and when?
- Rates at the short end are anchored at near or below zero – long end has recently risen (curve steepening, indicating confidence in the recovery and potentially inflation coming).
- Helicopter money: Ending here soon: another huge US stimulus programme expected soon. Again, will all this money overheat the economy and eventually lead to inflation? And if so when? - there are many examples of speculative bubbles forming now (dodgecoin!)

KEY QUESTION FOR INVESTORS: Should I chase markets here, with elevated valuations, when QE is about to fade?

GLOBAL ECONOMY: V SHAPED RECOVERY

1/ Short Term: we are seeing another bout of covid related weakness (further lockdowns in Northern Hemisphere: US, Europe and now China but for the time being markets are happy to look through it: the Consensus view is that at some point this year (via vaccination or herd immunity.. outside Oz) the world will return to some form of normality and the economic recovery will continue.

2/ Global Economies saw a V Shaped recovery in the second half of 2020

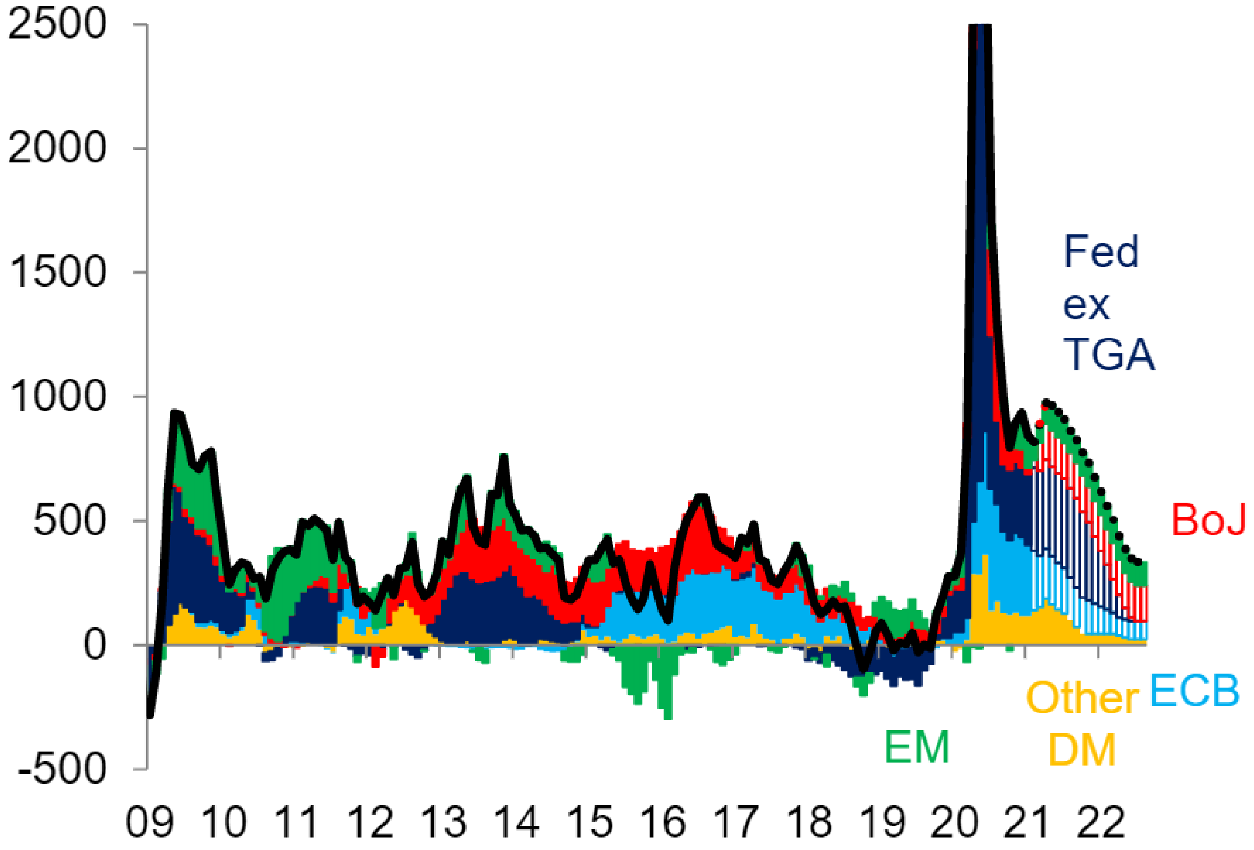
Consumer Spending (thanks to stimulus) has been strong
Property markets have taken off again (prices and building/starts).

3/ Savings rates (both business and personal) are extremely elevated, indicating pent up demand which should see growth continue to rebound as emergency stimulus fades.

CENTRAL BANK ACTIVITY: AS GOOD AS IT GETS?

Rolling 3 month global central bank security purchases - $bn

10. Tiptoeing slowly towards eventual exitRolling 3m global central bank securities purchases, $bn



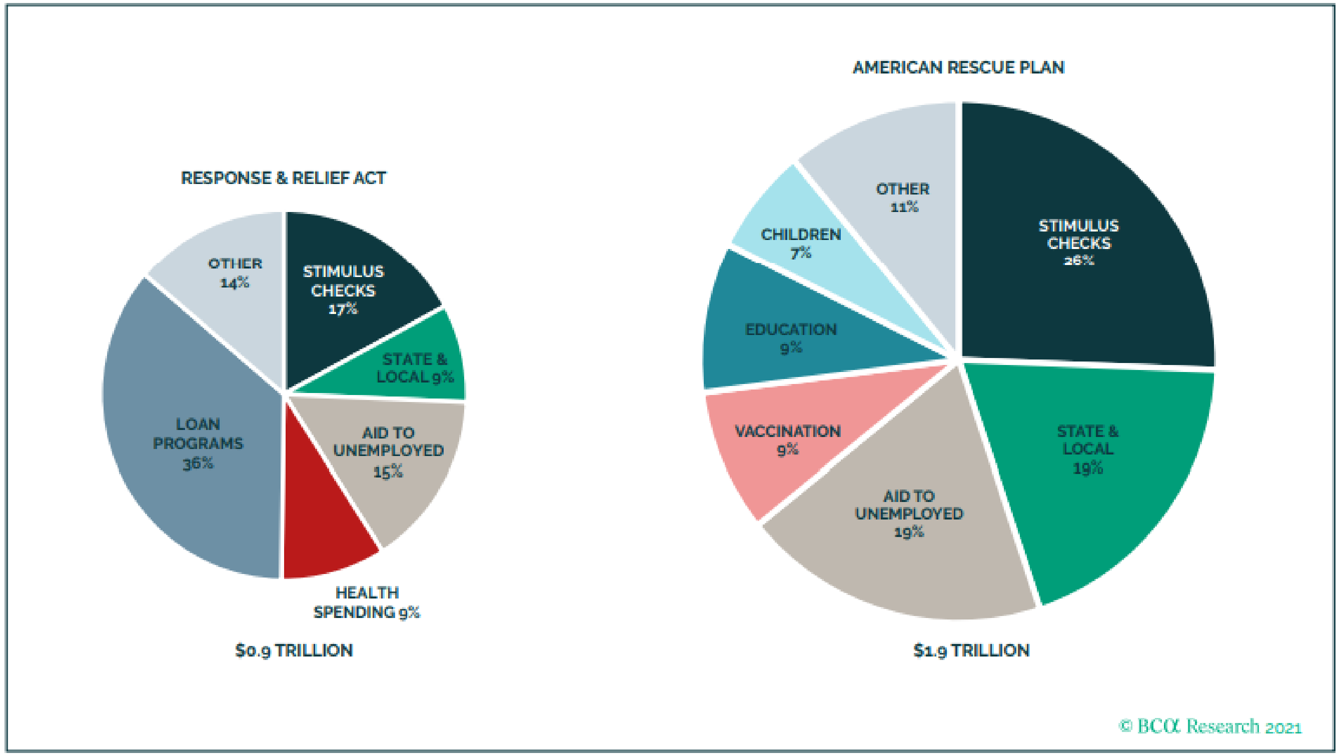
Source: Citi Research, national central banks.

GOVERNMENT (FISCAL)ACTIVITY: WHO WANTS SOME MONEY?

There is enough stimulus in the pipeline to close the US output gap the question is how long this will take (how long until the economy overheats = inflation, and how long will the fed and or markets tolerate higher inflation?)

These 2 would equate to **13%** of GDP on top of the lagged stimulus effect from last year.

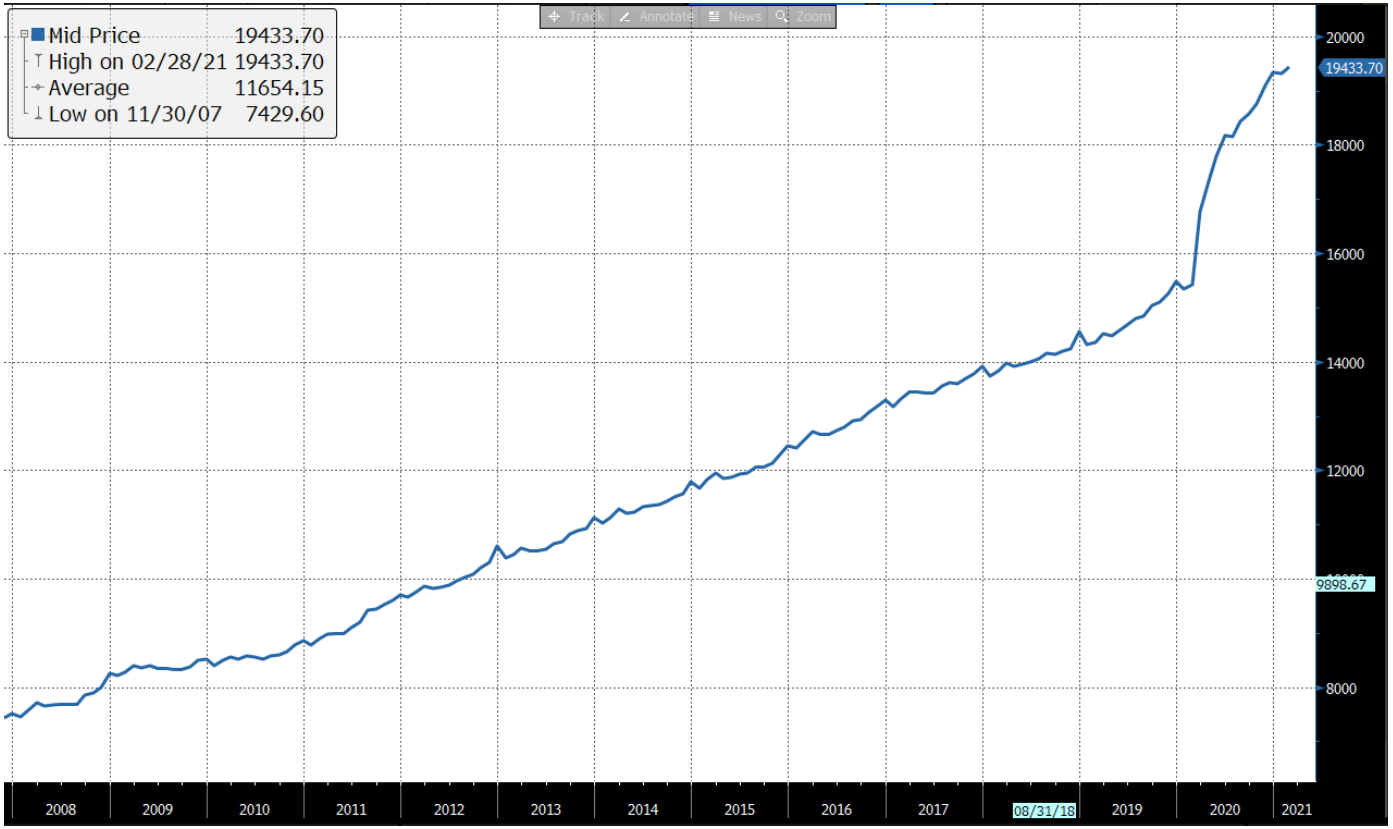
Stimulus Package Breakdowns



NOTE: THE RESPONSE AND RELIEF ACT WAS ADOPTED BY CONGRESS ON DECEMBER 21ST AND SIGNED BY PRESIDENT TRUMP ON DECEMBER 27TH, 2020. THE AMERICAN RESCUE PLAN WAS UNVEILED BY PRESIDENT BIDEN ON JANUARY 14TH, 2021, BEFORE HE WAS SWORN INTO OFFICE.
SOURCE: COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET.

MONEY SUPPLY (M2 US) : WHAT CONSEQUENCES?

US money supply has increased some 25% since the start of Covid, which is essentially 25% more than nominal GDP, so we've had a 25% increase in liquidity! (vs 7% during the GFC). Could inflation hit 4%-5% in 2 years?



MONEY SUPPLY (M2 CHINA) :

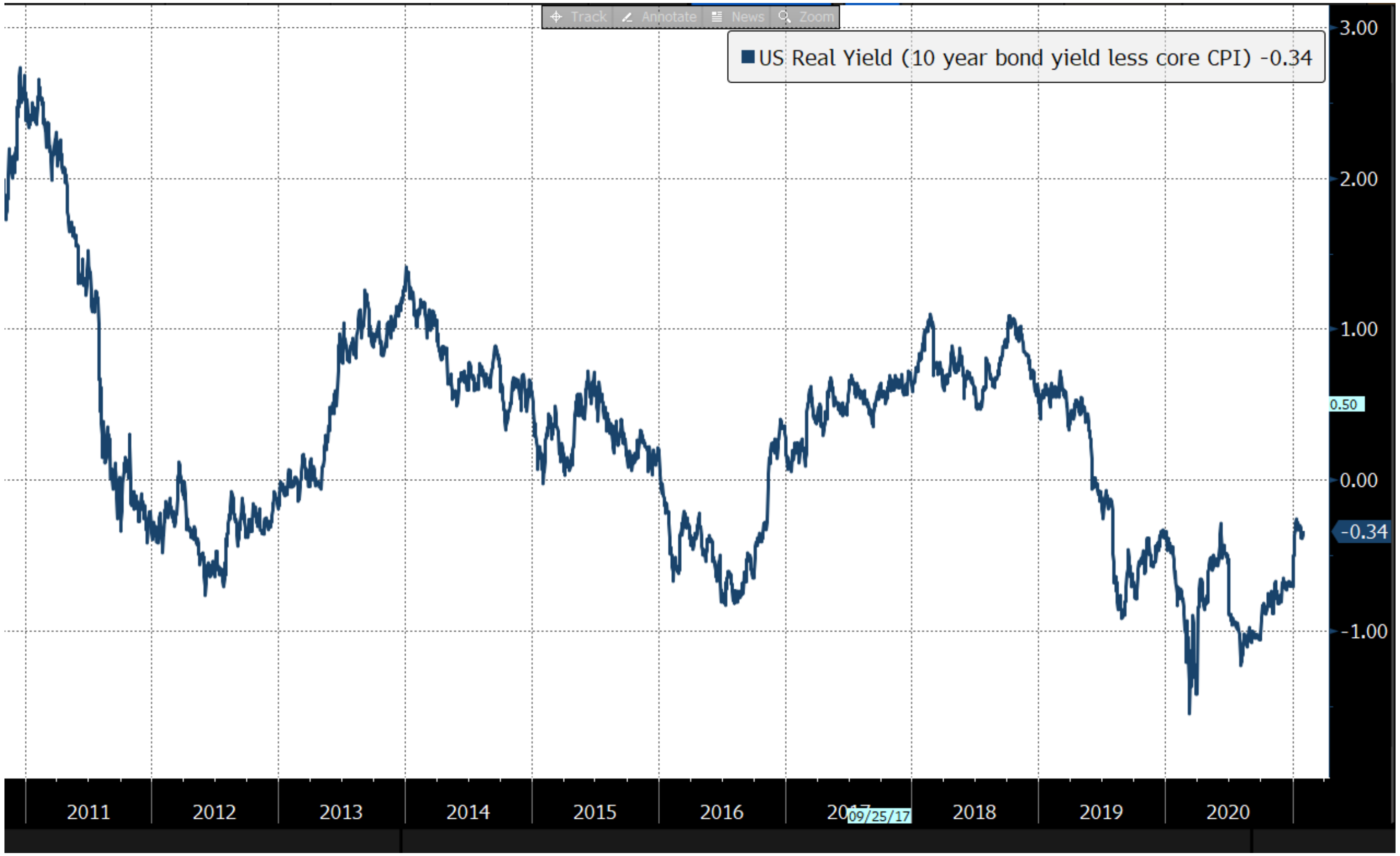
Chinese yoy growth in Money supply shows a much smaller, more targeted response that is now being reigned in again.

AT WHAT RISK FREE RATE DO WE SEE MONEY WITHDRAWN FROM GROWTH ASSETS?

Fed Funds rate and US 10 year Bond Yield: Short end anchored at zero (out to 3 years) but long is end pushing up.

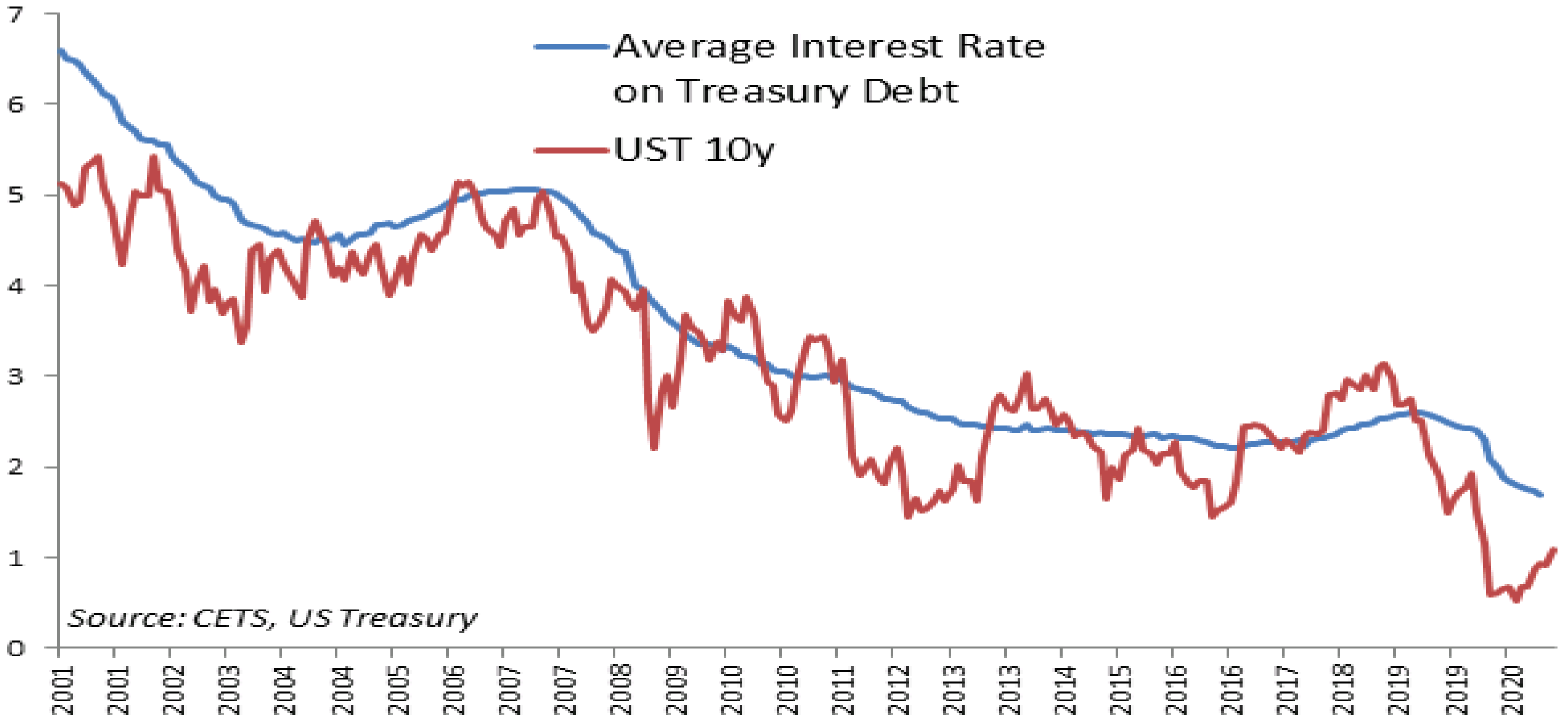
2011: BREAKDOWN OF MARKET FUNDAMENTALS (REAL YIELDS ARE BEST INDICATION OF MONEY FLOW – IS 1% THE BREAKING POINT? 2013 & 2018)

Real yields are a good indicator of money flows: since 2013, when real yields have been very low, (like now at -1.5%, then money flows into bod and equity markets). But, it is taking increasingly lower yields to keep money invested. If yields turned positive we would likely see large outflows – what would happen with say a 50 bps move?



AT WHAT RISK FREE RATE DO WE SEE MONEY WITHDRAWN FROM GROWTH ASSETS? 1.75%

The last 2 times the 10 year bond yield pushed above the average cost on Treasury Debt – we saw a sharp market sell off



Source: CETS, US Treasury

IS THIS A PROBLEM FOR 2021 OR CAN WE FORGET ABOUT IT UNTIL 2022?

Inflation will be the key :

As long as bond yields move higher in conjunction with improving growth expectations, stocks should remain supported.

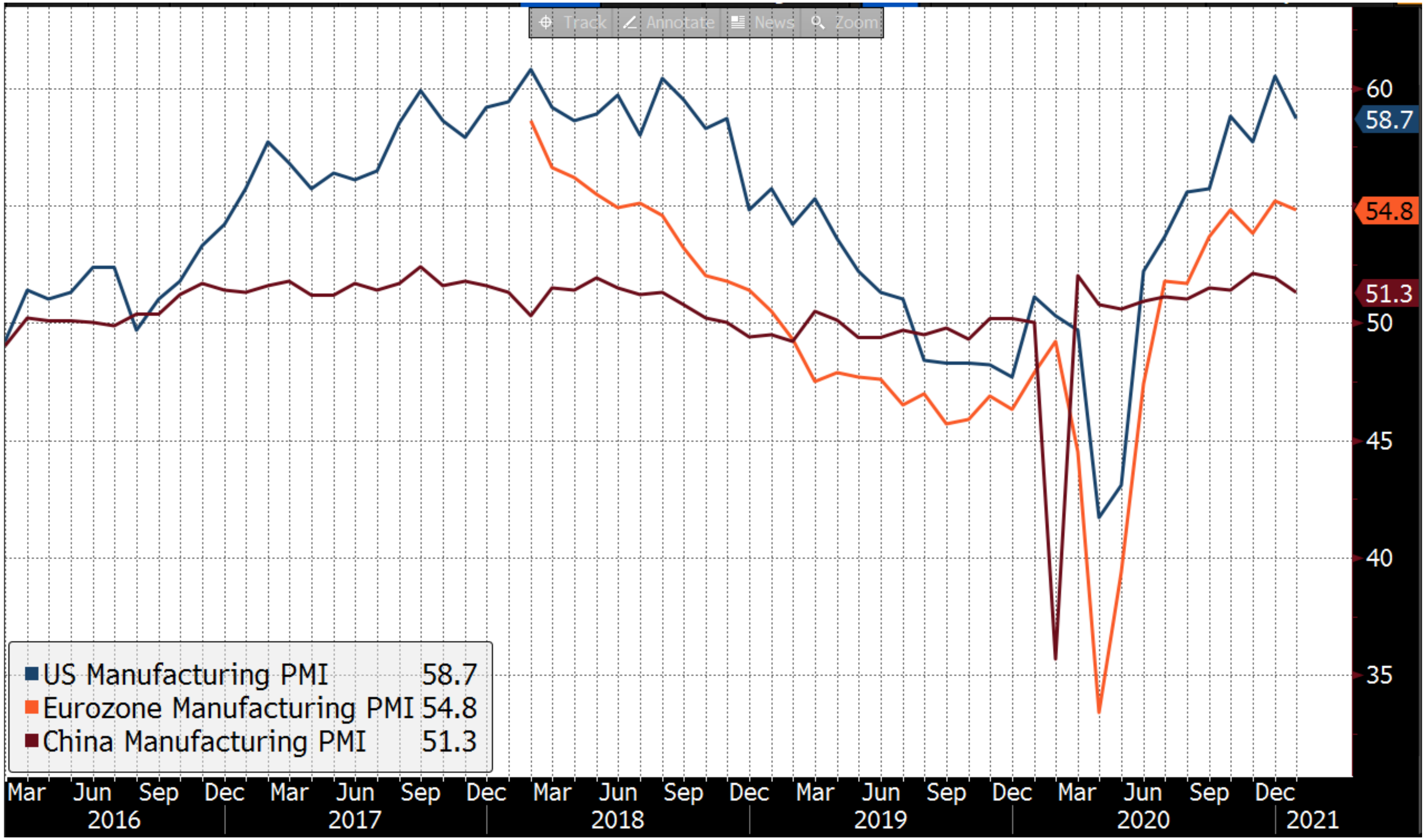
The bull market in equities will only end when the Fed starts to sound more hawkish and this would be as a result of inflation breaking out.

Markets (as they are now) will price this well ahead of any Fed moves.

And given current pricing, markets will be very sensitive to an increase in the discount rate/risk free rate (particularly growth sectors).

ECONOMIC ENVIRONMENT: V PLUS

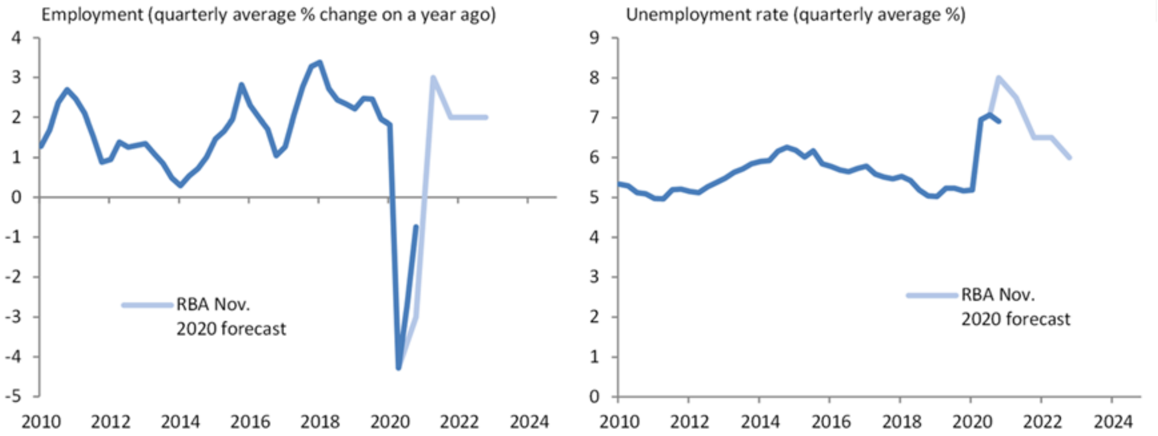
Doesn’t matter what data we look at, there was a clear V Shaped recovery in H2 2020.



AUS ECONOMY HAS REBOUNDED STRONGLY:

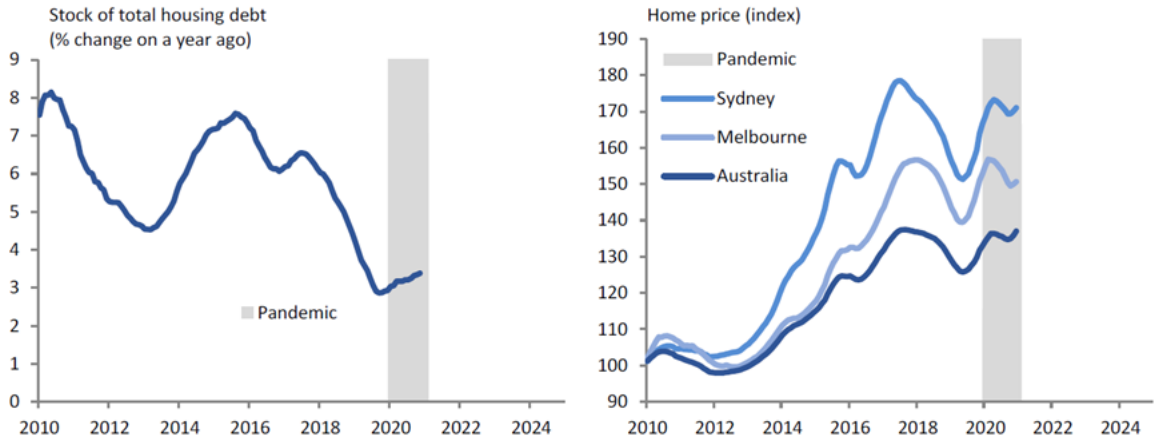
- GDP looks like coming in around -2.7% in 2020 with a rebound of probably close to 4% this year – activity looks like reaching the pre-covid level in Q3 this year

Figure 1: The labour market has recovered more quickly and more strongly than expected by the RBA in November



Note: The RBA forecasts are for Q4 2020, Q2 and Q4 2021, and Q2 and Q4 2022. Forecasts were interpolated for Q1 and Q3 in 2021 and 2022

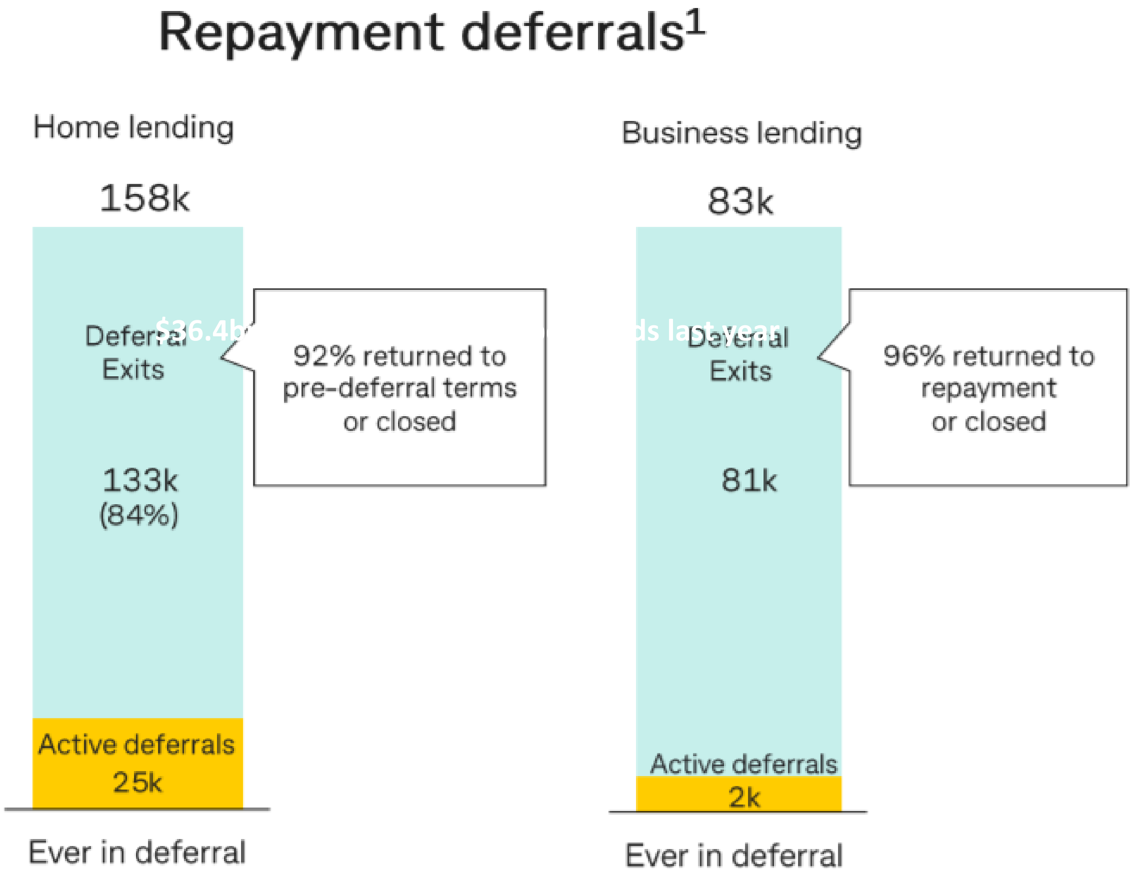
Figure 3: Financial stability is a non-issue at present



Source: Australian Bureau of Statistics, CoreLogic, Reserve Bank of Australia, Coolabah Capital

AUS ECONOMY HAS REBOUNDED STRONGLY:

- CBA deferred loans down from $51bn in June to $9bn now. Low interest rate is giving consumers a cash boost – plus Jobkeeper and Business grants plus $36.4bn withdrawn from Super last year



MARKETS: BORROWING FROM THE FUTURE

- Markets are now pricing: 1/ Strong Economic and Earnings Recovery

  2/ More Fiscal Stimulus

  3/ Rates at zero *forever*

- This feels a lot like 2018 (US Market) and also the start of last year (but hopefully we have a lot less excitement in 2021!).
- ***We now worry that investors have become complacent again and worry more about market rallies than pull backs.***
- Global Central Bank activity is creating shorter sharper cycles – will this be the shortest and sharpest ever?
- **Where alpha generation in 2020 was largely about buying the dislocation, the environment ahead will again require discipline to fade the rallies. You can't buy the dislocations without cash.** Having said that, the huge cash pool should see sell-offs bought aggressively in the short term.

MARKETS: SIGNS OF SPECULATION HAVE POPPED UP IN MULTIPLE PLACES

1/ Gamestop (Reddit/Robinhood), Bitcoin/Dogecoin, some Tech (Tesla?)

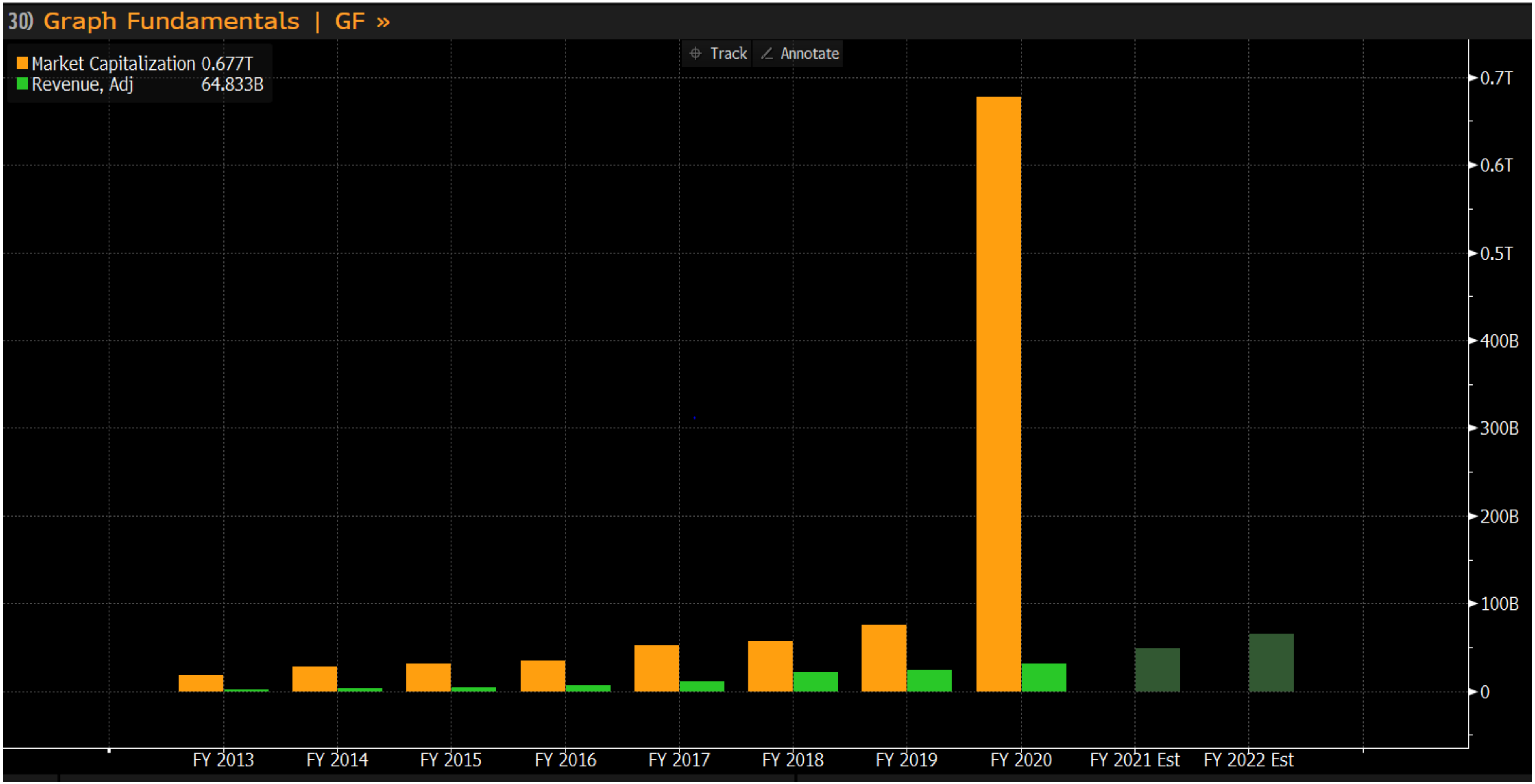
Figure 2. The less the earnings, the higher the price?
GS non-profitable tech index

Source: Bloomberg, Goldman Sachs.

Figure 3. Who's really driving bitcoin?
China Total Social Financing (12m flow) vs bitcoin ($)

Source: Bloomberg, PBOC.

MARKETS: SIGNS OF SPECULATION: **TESLA**



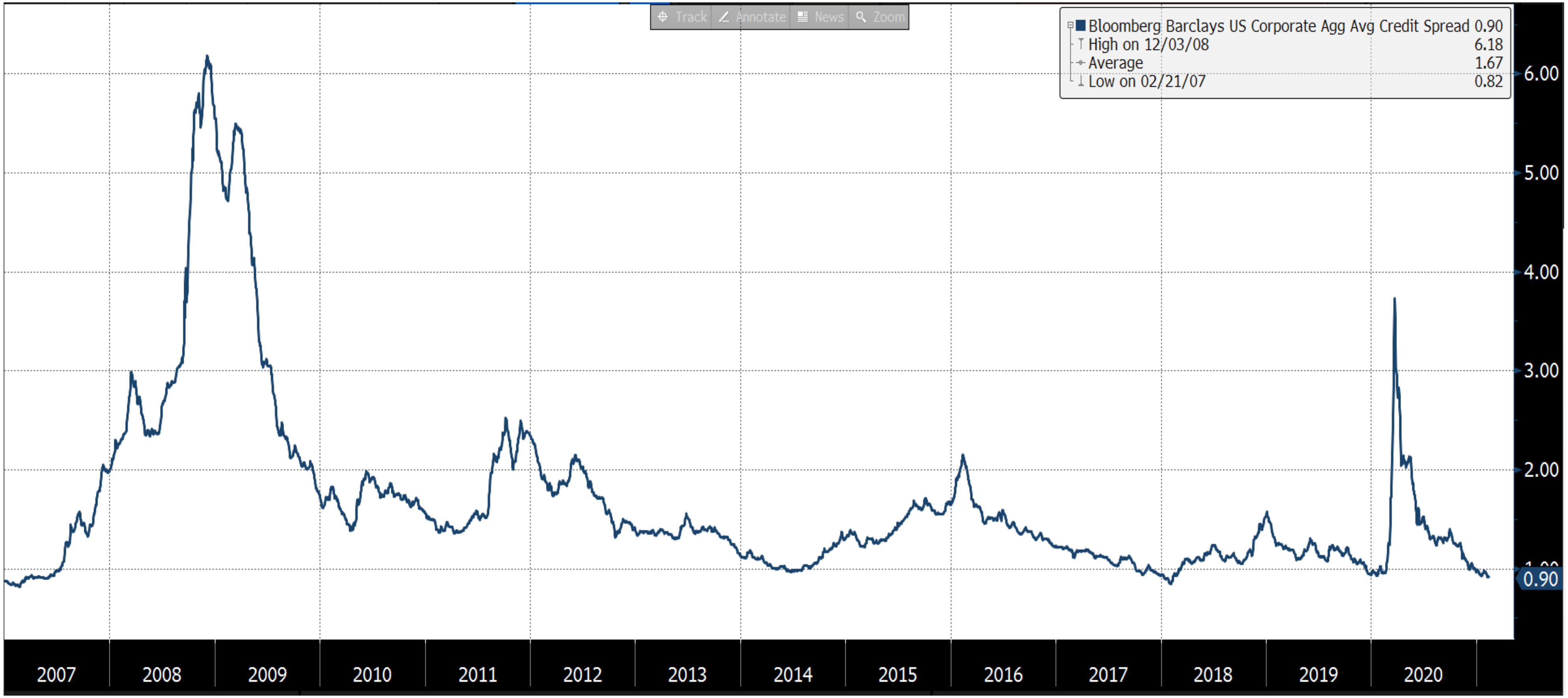
MARKETS: BACK TO THE FUTURE

- **US and China vs Eurozone and Aus.**

WATERSHED

MARKETS: BACK TO THE FUTURE

- **Credit Spreads are now back to pre-covid levels.**



WATERSHED

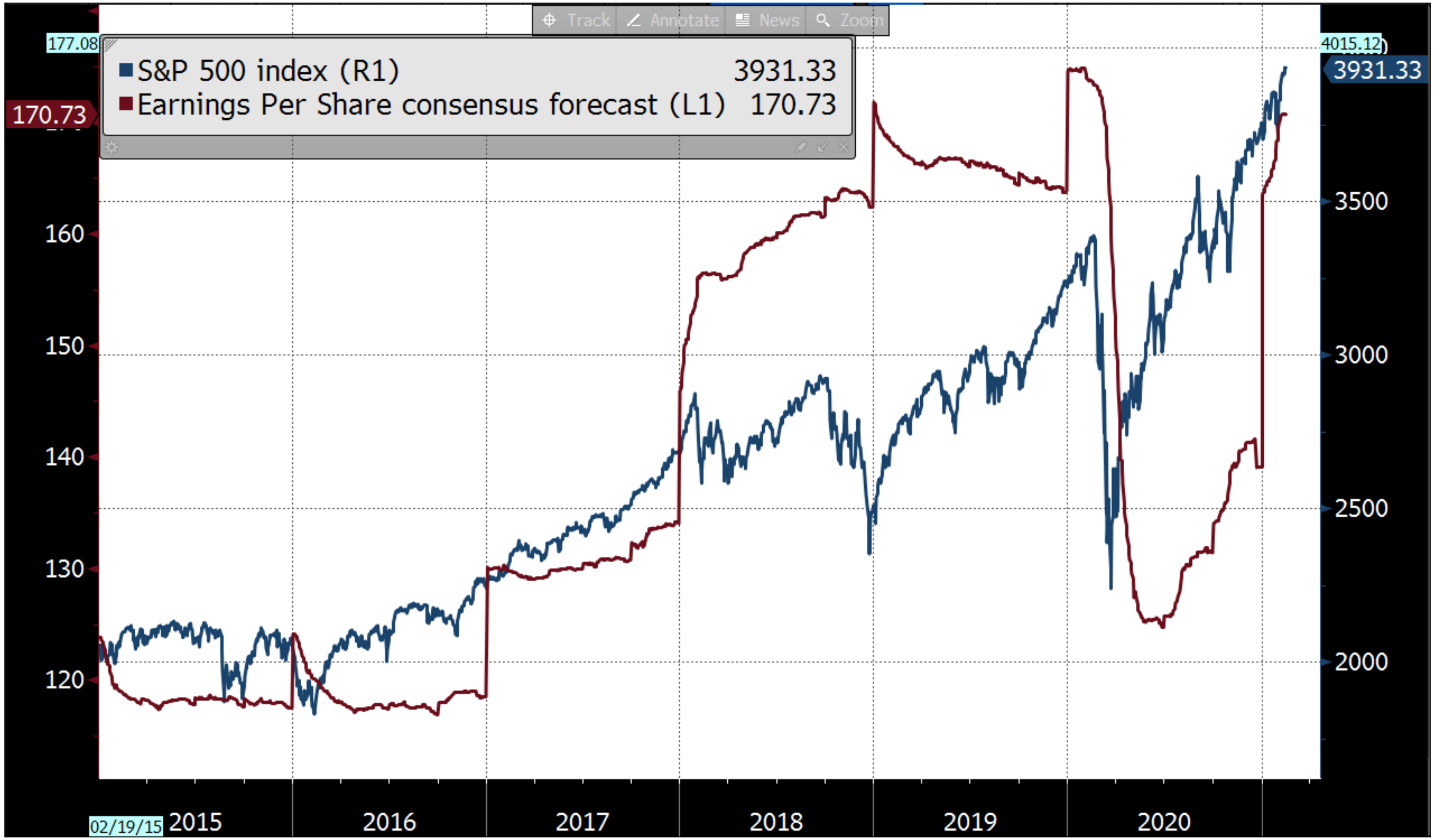
MARKETS: BORROWING FROM THE FUTURE

- ASX 200 is now trading on 24.8x earnings and 19 times 2022 earnings (i.e. consensus is now forecasting 36% earnings growth over the next 2 years. What need to happen in the short term, for markets to trade higher?)

WATERSHED

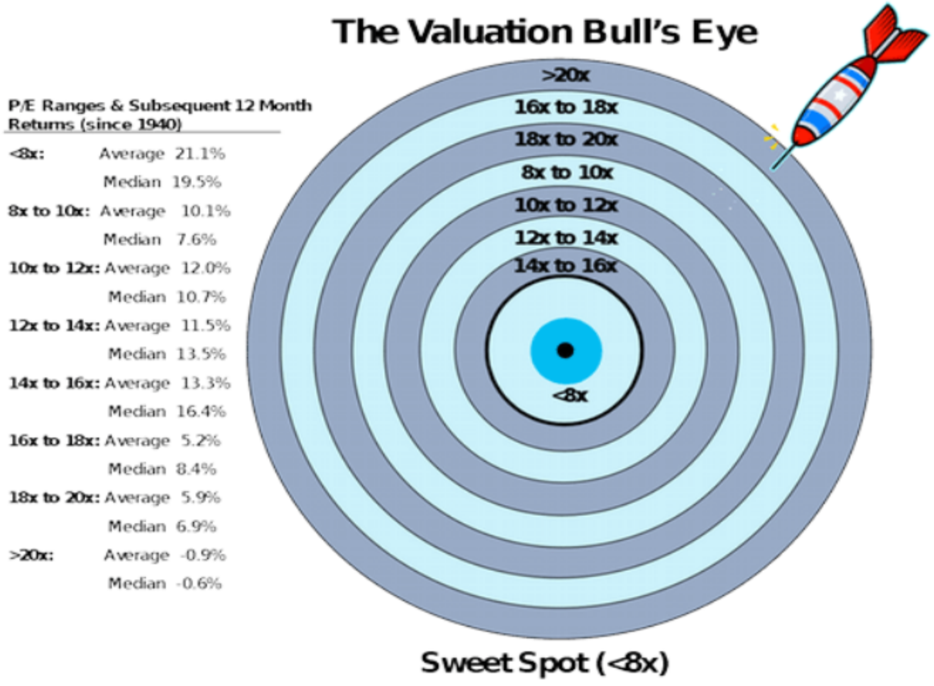
MARKETS: BORROWING FROM THE FUTURE

- S&P 500 earnings look like returning to pre covid levels this year. It is currently trading on 24.7 times forecast earnings and 18x two years out (with 26% earnings growth forecast)



BORROWING FROM THE FUTURE: HAVE WE ALREADY BANKED THIS YEARS RETURN?

P/E "Bull's Eye"



The Valuation Bull's Eye

P/E Ranges & Subsequent 12 Month Returns (since 1940)

<8x:	Average	21.1%
	Median	19.5%
8x to 10x:	Average	10.1%
	Median	7.6%
10x to 12x:	Average	12.0%
	Median	10.7%
12x to 14x:	Average	11.5%
	Median	13.5%
14x to 16x:	Average	13.3%
	Median	16.4%
16x to 18x:	Average	5.2%
	Median	8.4%
18x to 20x:	Average	5.9%
	Median	6.9%
>20x:	Average	-0.9%
	Median	-0.6%

Sweet Spot (<8x)

Source: FactSet. Haver Analytics and Citi Research – U.S. Equity Strategy

The dart reflects the 28.26x P/E multiple of the S&P 500 based on trailing four-quarter S&P 500 Operating EPS.

Current Valuation Metrics

S&P 500 Characteristics

The dart is here.

P/E (Trailing 4Q EPS): 28.26x

P/E (2021E EPS): 23.18x

Price to Sales: 2.93x vs. avg Price to Sales of 1.31x since 1985

Price to Book: 4.33x vs. avg Price to Book of 2.70x since 1985

Price to EBITDA: 18.37x

Market Value: $36.26 trillion

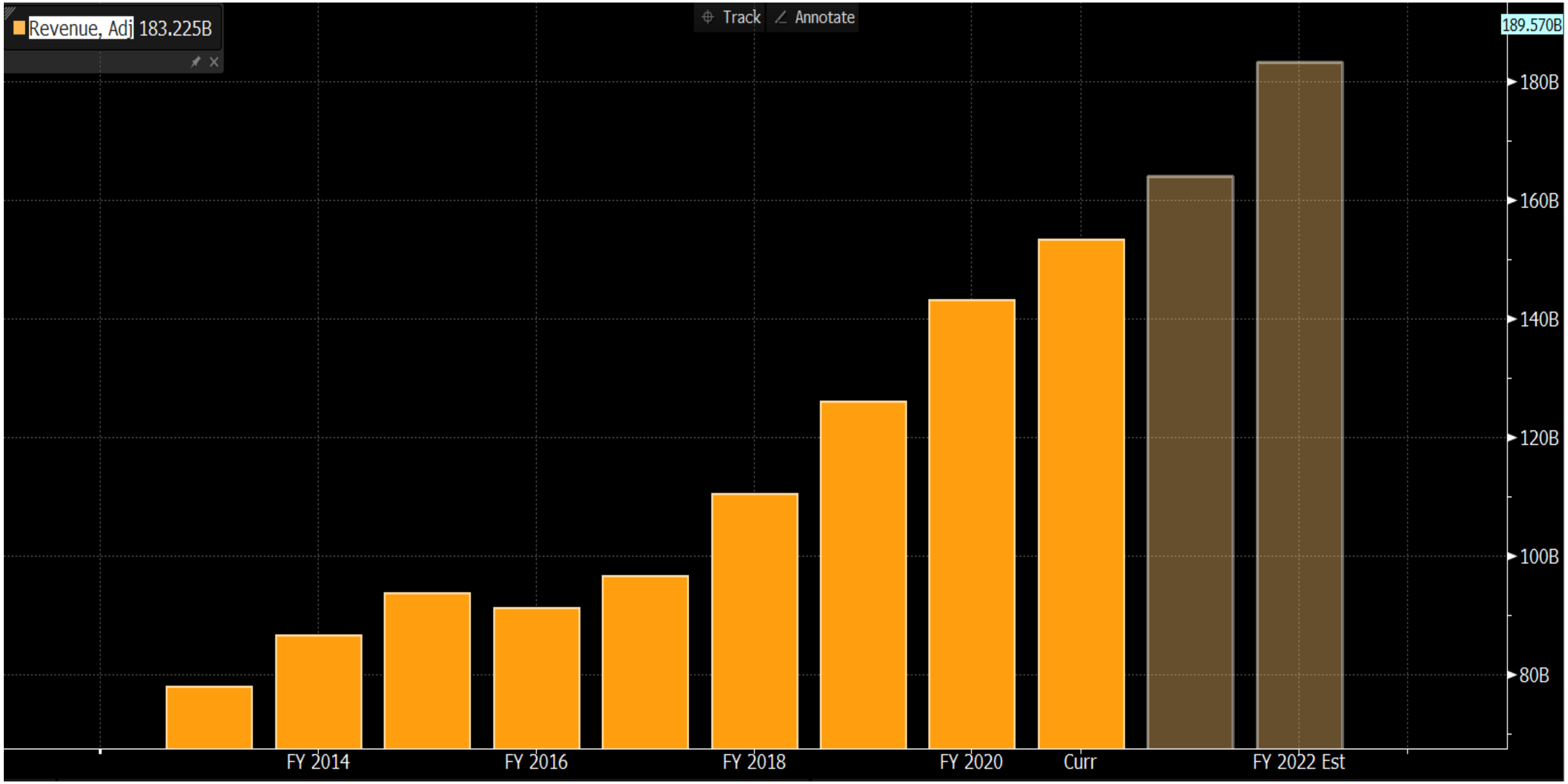
Dividend Yield: 1.49%

Citi Economic and Market Analysis S&P 500 Operating EPS forecast:

2015A = $118.20
2016A = $119.08
2017A = $132.95
2018A = $162.91
2019A = $164.58
2020E = $137.00
2021E = $167.00

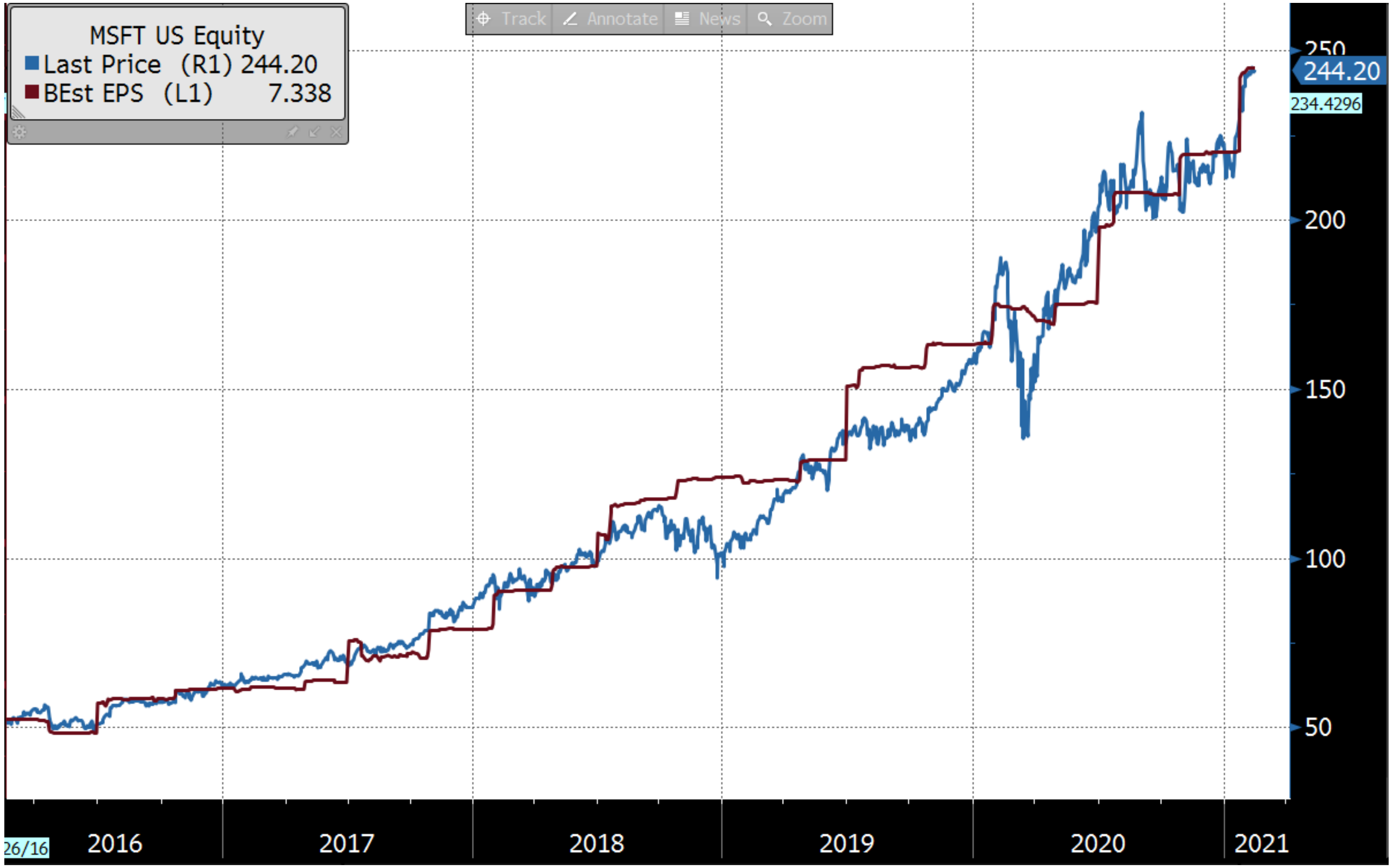
MICROSOFT: LARGEST STOCK WEIGHT

Microsoft Revenue (actual 2013-2020 and forecast) Trading on 36x trailing earnings and 32 times forecast earnings 1 year forward. MSFT has doubled EPS over the past 4 years.



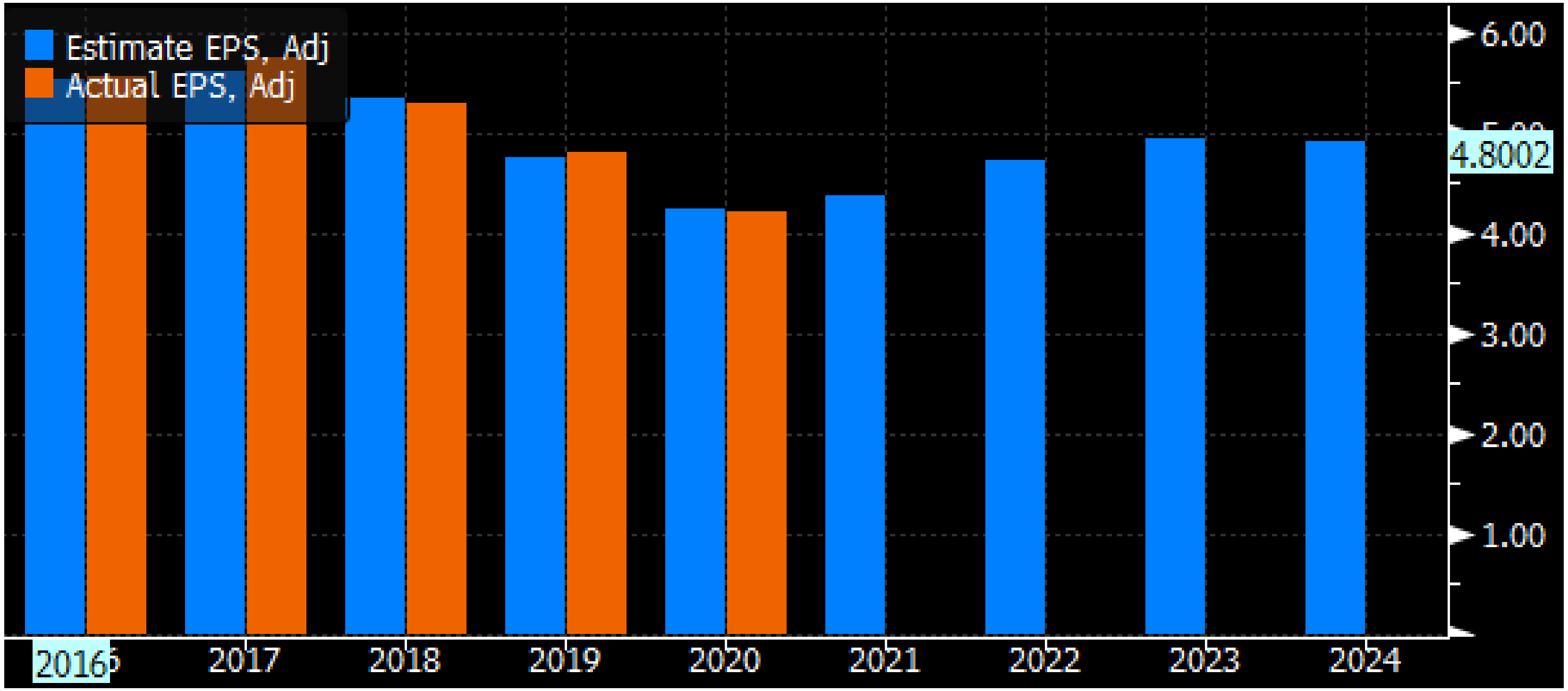
MICROSOFT: LARGEST STOCK WEIGHT

Microsoft share price has been driven by earnings growth



CBA: HOW HAS THE BEST AUSSIE BANK PERFORMED?

- No earnings growth for the 4 years leading up to Covid. While earnings are likely to recover to pre-covid levels over the next few years, we will have no earnings growth over the best part of a decade. (but the dividend yield of 4.26% in a zero rate environment remains attractive)



CBA: HOW HAS THE BEST AUSSIE BANK PERFORMED?

- Zero rates has driven multiple expansion well beyond historical norms. Current PE of 18.4 is 14% above the long term average – i.e. borrowing from the future

PORTFOLIO POSITIONING: NAVIGATING MARKETS

- After buying the dip aggressively in March last year we were overweight Equities vs Fixed Income. With valuations now full we have started to slightly increase cash levels in equity mandates: Aus Share cash weight now 12.6%, Emerging Leaders 12%, International Share (US) 6%, International Share (ROW) 14%. We also hold a Nasdaq short (2% weight).
- Within equites we Increased EM, Japan, Euro Exposure last year (cyclical recovery trade)- but recently started to take some profits
- This has seen the Equity Exposure of our Multi-Asset Models move from overweight to now slightly underweight (58% vs 60% benchmark for Balanced- from 69%).
- Within Fixed Income we hold no developed market duration – Preference for Global Credit, Domestic Floating Rate Corporate (Hybrids) and Emerging Market Bonds.
- Looking at introducing (increasing) alternative exposure again
- Happy to have US Dollar Exposure Unhedged (natural risk hedge)

PORTFOLIO POSITIONING:

Risk Profile - **Watershed Balanced**	Minimum %	Neutral %	Maximum %	Look Through Tactical %
CASH	0%	**5%**	40%	8%
FIXED INTEREST / INCOME SECURITIES	20%	**35%**	60%	29%
LISTED PROPERTY	0%	**5%**	10%	0%
AUSTRALIAN SHARES	10%	**30%**	70%	36%
INTERNATIONAL SHARES	10%	**25%**	60%	22%
ALTERNATIVES	0%	**0%**	15%	3%

Recommended Asset Allocation		
Assets	**$**	**%**
CASH	$81,873	8.19%
FIXED INTEREST / INCOME SECURITIES	$294,570	29.46%
LISTED PROPERTY	$0	0.00%
AUSTRALIAN SHARES	$358,585	35.86%
INTERNATIONAL SHARES	$215,959	21.60%
ALTERNATIVES	$27,653	2.77%
Leverage (short)	$21,360	2.14%
Total	**$1,000,000**	**100.00%**

PORTFOLIO PERFORMANCE:

Gross Performance %	**1 m**	**3 m**	**6 m**	**1 yr**	**2 yrs**	**3 yrs**	**4 yrs**	**Inception**	**Inception Date**
WFM Conservative	0.14%	5.39%	8.05%	6.21%	8.30%	6.29%	7.16%	7.97%	01-06-16
FE UT PG Multi Asset Moderate Index	-0.15%	3.25%	3.99%	0.96%	4.95%	3.67%	4.10%	3.92%	
Relative Performance	**0.29%**	**2.14%**	**4.05%**	**5.25%**	**3.34%**	**2.62%**	**3.06%**	**4.05%**	
WFM Balanced	0.33%	6.76%	9.28%	7.19%	10.01%	7.12%	8.48%	8.42%	01-05-16
FE UT PG Multi Asset Balanced Index	0.02%	6.00%	6.97%	0.89%	6.69%	4.66%	5.63%	5.50%	
Relative Performance	**0.31%**	**0.75%**	**2.31%**	**6.31%**	**3.32%**	**2.46%**	**2.85%**	**2.92%**	
WFM Growth	0.47%	7.89%	10.18%	8.18%	11.70%	8.09%	9.63%	10.20%	01-05-16
FE UT PG Multi Asset Growth Index	0.02%	7.71%	8.98%	0.47%	7.85%	5.21%	6.63%	6.87%	
Relative Performance	**0.45%**	**0.18%**	**1.20%**	**7.71%**	**3.85%**	**2.88%**	**3.00%**	**3.33%**	

PORTFOLIO PERFORMANCE:

Gross Performance %	1 m	3 m	6 m	1 yr	3 yrs	5 yrs	7 yrs	9 yrs	Inception	Date
WFM Australian Share	-0.31%	9.50%	9.34%	2.46%	5.65%	9.61%	7.74%	9.30%	7.30%	05-08-10
S&P/ASX 200 Accum	0.31%	11.89%	12.98%	-3.11%	7.00%	10.03%	7.90%	9.54%	8.28%	
Relative Performance	**-0.62%**	**-2.38%**	**-3.64%**	**5.57%**	**-1.35%**	**-0.42%**	**-0.16%**	**-0.25%**	**-0.98%**	
WFM Income Portfolio	-0.26%	2.41%	5.66%	2.92%	3.57%	5.85%	4.42%	4.93%	5.51%	30-08-10
WFM Including Franking	-	-	-	3.91%	4.82%	7.21%	5.77%	6.28%	6.86%	
UBS Bank Bill Index	0.01%	0.03%	0.06%	0.32%	1.21%	1.48%	1.77%	2.12%	2.54%	
Relative Performance	**-0.27%**	**2.38%**	**5.60%**	**3.59%**	**3.61%**	**5.73%**	**4.00%**	**4.17%**	**4.32%**	
WFM Emerging Leaders	1.89%	13.64%	23.92%	26.11%	13.30%	12.71%	14.73%		14.65%	06-08-13
S&PASX Small Ords Accum	-0.25%	13.03%	18.34%	5.38%	6.66%	11.55%	8.64%		8.27%	
Relative Performance	**2.14%**	**0.61%**	**5.58%**	**20.73%**	**6.64%**	**1.16%**	**6.09%**		**6.38%**	
WFM International Share	1.04%	5.86%	6.51%	3.95%	13.24%	14.00%	15.49%	18.68%	16.11%	31-01-10
MSCI World Index Ex Aus (AUD)	-0.45%	6.41%	8.52%	0.86%	10.35%	11.57%	11.76%	15.27%	11.67%	
Relative Performance	**1.49%**	**-0.55%**	**-2.01%**	**3.08%**	**2.89%**	**2.43%**	**3.74%**	**3.41%**	**4.44%**	
WFM International ETF	1.11%	7.94%	10.17%	11.42%	3.14%	8.14%			7.43%	04-05-15
MSCI World Index (AUD)	-0.45%	6.41%	7.70%	-0.84%	8.30%	9.62%			7.65%	
Relative Performance	**1.56%**	**1.53%**	**2.47%**	**12.26%**	**-5.16%**	**-1.48%**			**-0.22%**	

Questions

Open Discussion

AUD: HAPPY TO REMAIN UNHEDGED

- AUD has rallied strongly over the past year

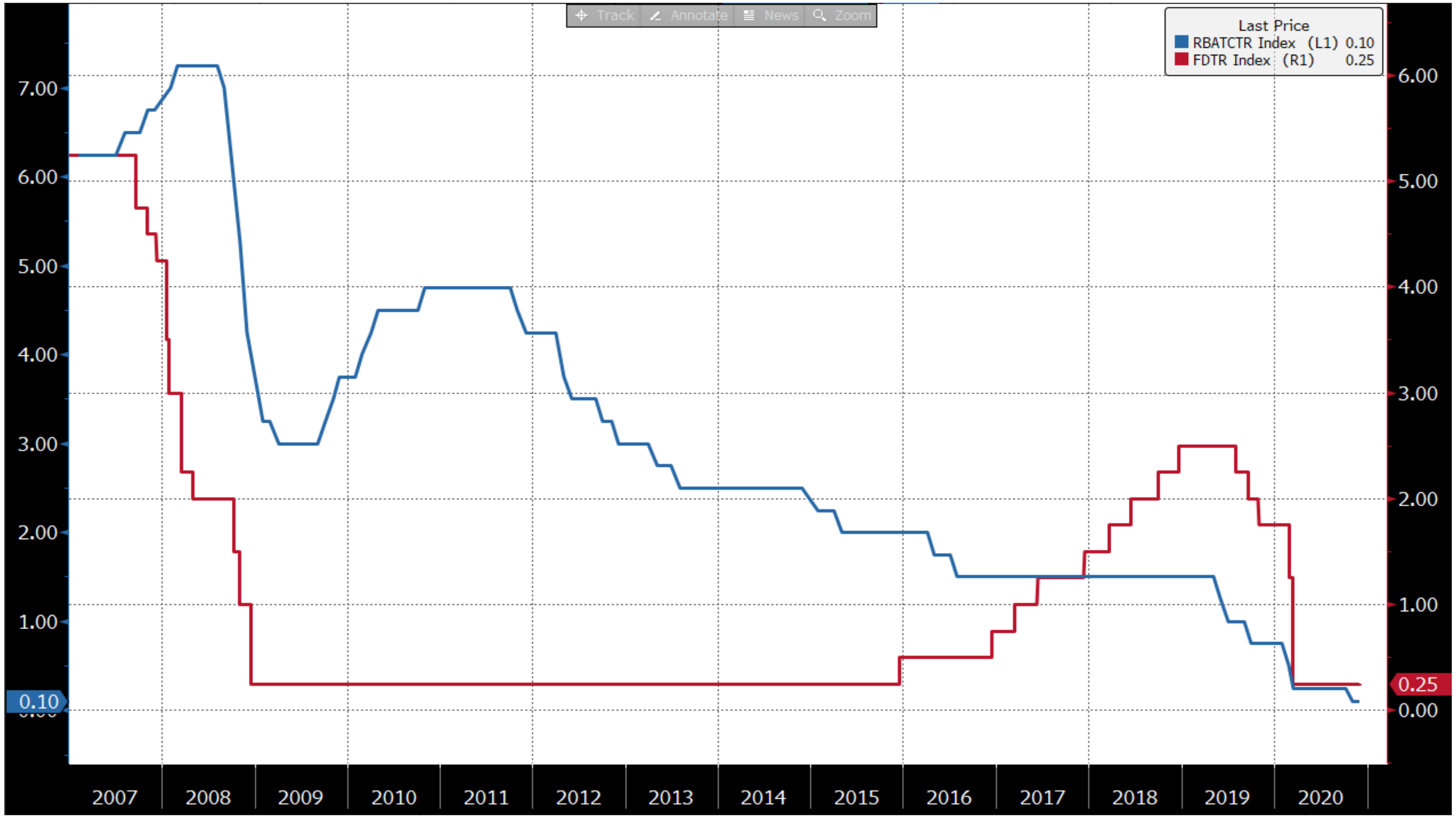
AUD: HAPPY TO REMAIN UNHEDGED

- Upper end of range since 2015

WATERSHED

AUD: HAPPY TO REMAIN UNHEDGED

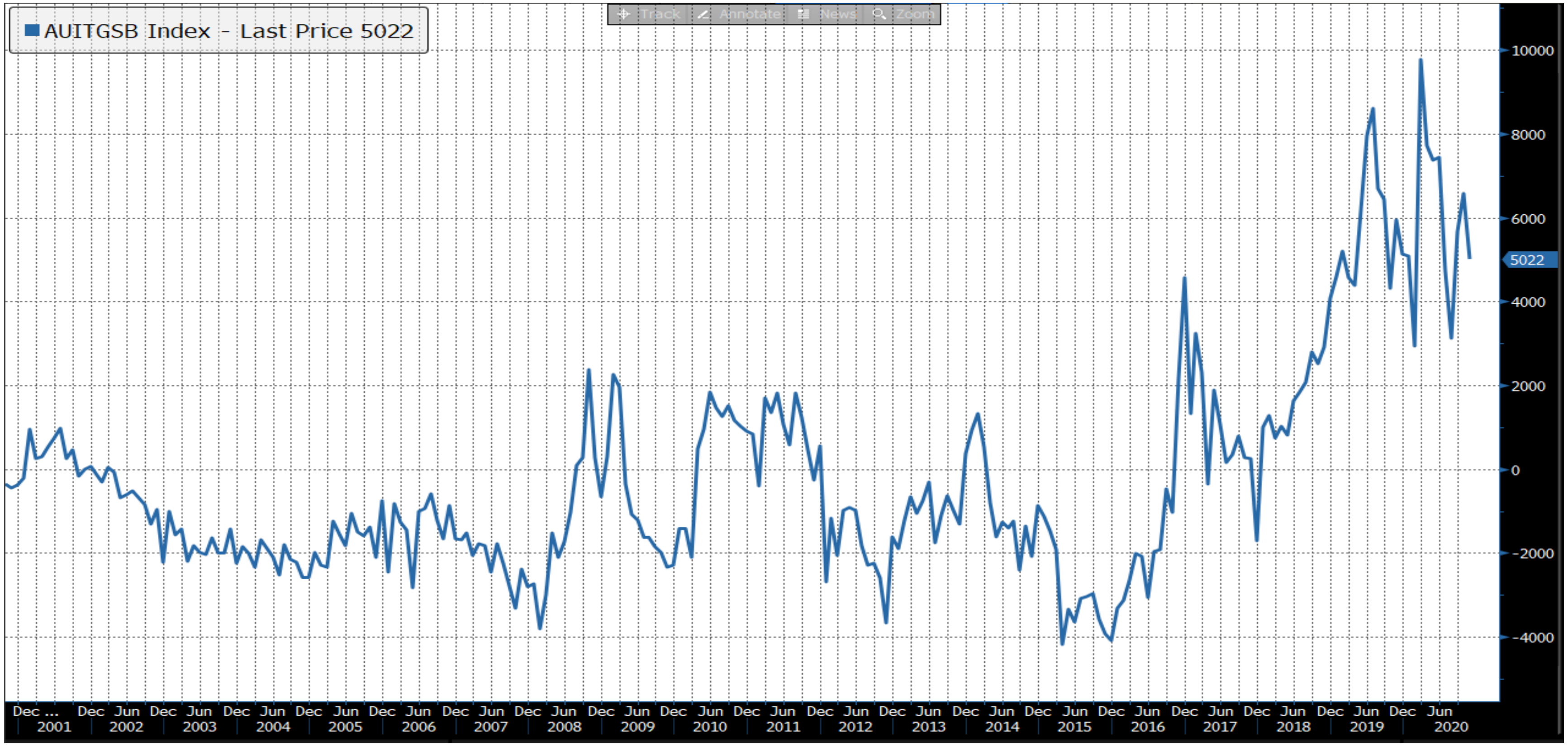
- There is now, no interest rate advantage



WATERSHED

AUD: HAPPY TO REMAIN UNHEDGED

- So why has the dollar rallied? Trade Balance (which is Iron ore and LNG)
  - So, will remain strong as long as cyclical recovery is intact and Fe Price remains strong



WATERSHED

FUNDS MANAGEMENT

Thank you for your time today, and feel free to call or connect with us.

watershedgroup.com.au ☎ +61 (03) 9614 8899

contact@watershedgroup.com.au