VERTiUM ASSET MANAGEMENT

Vertium Equity Income Fund

Fund Update | Quarter to 31 December 2017

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

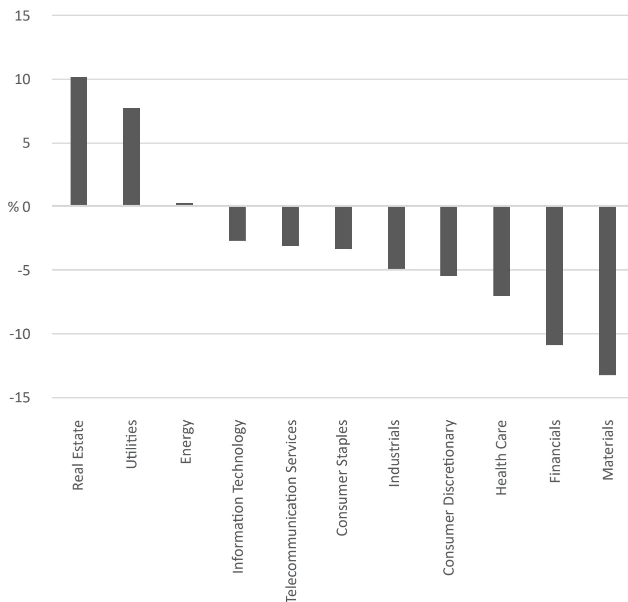
Total returns*

	1 month %	3 months %	Inception %
Vertium Equity Income Fund			
Income	*0.97*	*0.97*	*2.09*
Growth	*-0.52*	*1.99*	*3.07*
Total return	**0.44**	**2.96**	**5.16**
S&P/ASX 300 Accumulation Index			
Total return	**1.86**	**7.74**	**5.86**

Month-end unit prices^

Application	NAV	Redemption
$1.0426	$1.0400	$1.0374

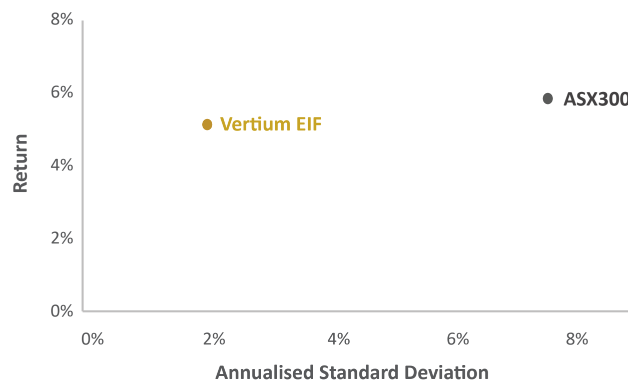
GICS active exposure



Top 10 holdings#

Company	ASX code
ANZ Banking Group	ANZ
Westpac Banking Corp	WBC
Vicinity Centres	VCX
Amcor Limited	AMC
Lendlease Group	LLC
Spark Infrastructure Group	SKI
Wesfarmers Limited	WES
AGL Energy Ltd	AGL
CYBG Plc	CYB
Investa Office Fund	IOF
Number of stocks	23

Return vs risk (since inception)



Exposure

Size exposure	%	Option exposure	%
Large cap	48.38	**Shares**	77.57
Mid cap	11.34	**Call options**	-11.67
Small cap	7.87	**Put options**	1.68
Effective cash	32.40	**Effective cash**	32.40

Quarterly commentary

Dear investors,

During the December 2017 quarter, the Fund delivered a total return of 3.0% versus 7.7% for the S&P/ASX300 Accumulation Index (market). The Fund also paid one cent per unit distribution for the quarter and is on track to deliver a yield greater than the market by the end of the financial year.

Market performance over the quarter was very strong driven by the exuberant small cap sector and continued strength in the resource sector. Since inception (1 May 2017), the Fund has delivered a total return of 5.2% versus the market at 5.9% but importantly it was delivered with lower levels of risk. Hence, in fast rising markets such as the recent quarter, the strategy is expected to lag because chasing the latest themes or hottest stocks would increase the potential risk of capital loss.

Our strength is delivering returns with a lower risk profile using our margin of safety approach in identifying mispriced securities. This works best when markets are not exuberant. Over a full market cycle, where irrational periods are washed out, we aim to outperform the market with substantially less risk and to deliver a higher level of income. Our conservative strategy is highlighted on the return versus risk chart on page one of this quarterly report. Since inception, the total return to risk ratio is about 3-to-1, where our conservative strategy has delivered a very low risk profile (about 70% below market).

The sky is not falling, but storm clouds are brewing.

The sky is not falling was the message from our last quarterly. Our message was that the overall market did not show excessive valuations, which generally is a precursor to stock market corrections. However, our market outlook has now dimmed due to the recent 'risk-on' rally where most of the year's return was delivered in the last three months. While large cap industrials generally exhibit reasonable valuations, we are beginning to observe pockets of irrationality, with prices running ahead of fundamentals. In the following commentary, we highlight two areas of the market where we believe risk is taking a back seat.

1st storm cloud: Small cap valuations

Since the Fund's inception, small companies (S&P/ASX Small Ordinaries Accumulation Index) delivered a total return of 18.6%, trouncing their larger peers (S&P/ASX100 Accumulation Index) which delivered a 4.5% total return.

Small cap stocks with very high multiples and/or volatile earnings have performed very well (maybe too well) over the quarter. Specifically, in the current environment there is a lot of hype and momentum in miners (where related to electric vehicles, revived commodity prices, and mining contractors), technology, and Chinese consumer food themes.

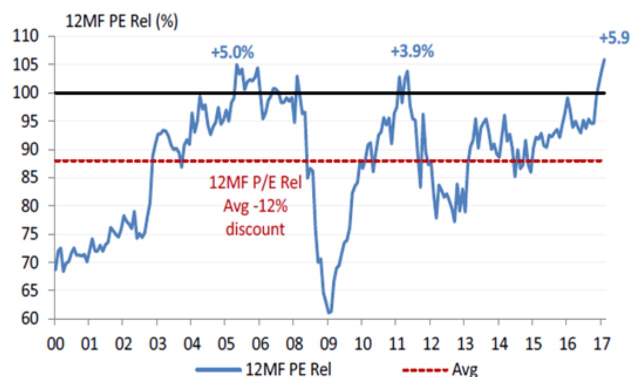
Table 1. Small cap stocks exposed to hot themes

		Quarterly Return	Yearly Return	Market Cap ($b)	PE (next 12 months)
Miners (Electric Vehicle Related)					
PLS	Pilbara Minerals	76%	123%	1.9	32x
ORE	Orocobre	56%	54%	1.4	27x
GXY	Galaxy Resources	47%	46%	1.6	17x
SYR	Syrah Resources	31%	49%	1.3	no profit
LYC	Lynas	12%	199%	1.2	no profit
Miners (other)					
BPT	Beach Petroleum	53%	51%	2.8	16x
SBM	St Barbara	45%	90%	2.0	11x
MIN	Mineral Resources	30%	79%	4.0	12x
SAR	Saracen Mineral	29%	71%	1.4	13x
WHC	Whitehaven Coal	27%	79%	4.6	12x
Mining Contractors					
ASL	Ausdrill	32%	112%	0.9	19x
SVW	Seven Group Holdings	28%	101%	4.9	19x
MND	Monadelphous	11%	59%	1.6	24x
Technology					
WTC	Wisetech Global	63%	151%	4.1	93x
APT	Afterpay Touch	43%	140%	1.0	47x
ALU	Altium	23%	67%	1.7	34x
Chinese Consumer Food					
BKL	Blackmores	43%	66%	3.0	36x
BAL	Bellamy	39%	60%	1.2	30x
A2M	A2 Milk	26%	261%	5.4	30x

Source: Vertium, Factset

After the surge in valuations over the quarter, small caps relative to the Top 100 stocks are now at extreme levels. If history is a guide this is not sustainable.

Chart 1. Relative PE multiple of the Small Ordinaries versus the ASX100



Source: Morgan Stanley

When growth is hard to come by in our challenged macro environment, investors are increasingly prepared to pay higher prices for any growth. The 'fear of missing out' mentality is turning many high-priced securities into lottery style tickets – very slim odds with the perception of winning large payoffs.

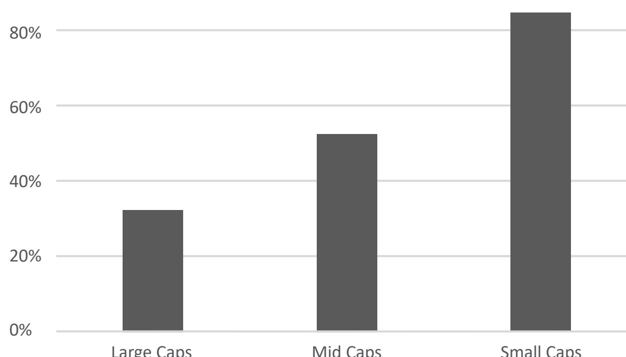
No doubt, the payoffs are large for fantastic businesses that can reinvest at high returns on capital for a very long period. However, when you attempt to pay extremely high prices for perceived growth companies two things work against you:

i. A wonderful business at a high price can be a terrible investment. For example, Walmart is a fantastic company that once was a high-flying growth company. Since its IPO in the 1970s as a small company its share price has delivered double digit returns for almost 30 years. But it all came to a standstill in late 1999 when it's one year forward price earnings (PE) multiple hit 50x. By the end of the next decade, Walmart had experienced fantastic growth with earnings per share (EPS) nearly tripling. However, its share price was more than 20% below its 1999 peak! It was a wasted decade for Walmart investors.
ii. Finding a wonderful business with a long runway for earnings growth is rare. There is a very good chance that most stocks in a portfolio will not exhibit long-term earnings growth like Walmart. While short-term earnings growth may look intact, over the long term the law of averages applies – very few companies can sustain high growth rates. Hence, growth perceptions can be very fickle.

When a mediocre business is bought for a very rich price it sets the foundation for extreme volatility. It was not long ago that we observed some high-flying small cap stocks that crashed when their stellar growth stories changed. For example, Mayne Pharma (MYX) was a recent market darling because earnings were revised up by about 80% over two years prior to its share price peak in August 2016. When the euphoria was at a crescendo the stock's PE multiple hit 27x making it a giant amongst its small cap peers with a market capitalisation of $3.2 billion. However, the fear of missing out mentality quickly dissipated when the company revised its profits lower in late 2016. Consequently, MYX's share price collapsed and it was the worst performing small cap stock in 2017 delivering a -48% total return.

MYX is not an isolated case because small cap stocks in general exhibit high levels of volatility (other notable mentions include TPG Telecom, which lost 60% from peak to trough, and APN Outdoor, which lost 35% in one day!). Changing perceptions, leading to excessive share price volatility, is to be expected more so from small cap stocks compared to large cap stocks. Over the last decade the average price range between the 12-month high and the low for small cap stocks is about 83%. As illustrated in chart 2, the price range of small caps is historically about three times greater than that of large cap stocks.

Chart 2. Average price range (12-month high and low) for large, mid and small cap stocks between 2006 and 2016



Source: Vertium, Factset

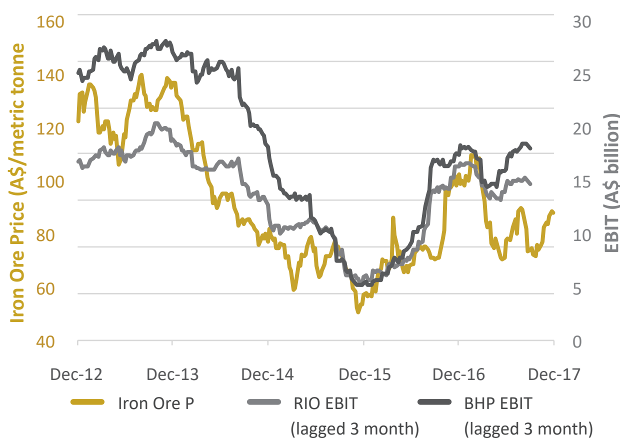
High levels of volatility suggest that perceptions change far more often than the fundamentals. It is particularly the case for small cap stocks, so when valuations are very stretched, then buyer beware – volatility works both ways.

2nd storm cloud: Resource valuations

While the Top 100 stocks have been left behind by the small cap sector, the Resources sector within the ASX100 has been on fire. The S&P/ASX100 Resources Accumulation Index has returned 22.7% over the eight months since the inception of the Fund. In comparison, the S&P/ASX100 Industrials Accumulation Index delivered a very modest 1.2% return.

Since the commodity price scare in 2015, resource giants like BHP Billiton (BHP; 14.7% quarterly return) and Rio Tinto (RIO; 14.0% quarterly return) have taken substantial steps to lower their operating costs and deleverage their balance sheets. However, it does not change the fact that their profits are significantly driven by the iron ore price – 44% of BHP's earnings and 70% of RIO's earnings were derived from iron ore in 2017.

Chart 3. AUD iron ore price versus BHP and RIO's rolling EBIT (next 12 months)

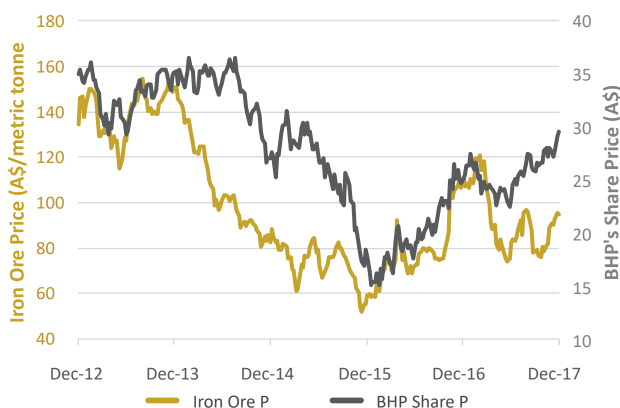


Note: EBIT is lagged by three months to the iron ore price because it takes about three months for sell side analysts to revise their earnings estimates.

Source: Vertium, Factset

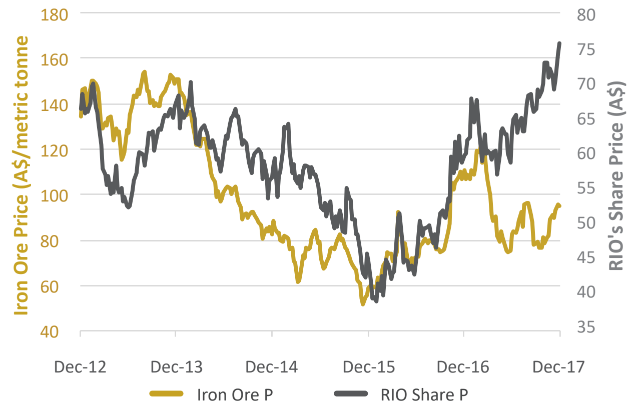
Consequently, the share prices of both BHP and RIO generally track the iron-ore price.

Chart 4. AUD iron ore price versus BHP's share price



Source: Iress

Chart 5. AUD iron ore price versus RIO's share price



Source: Iress

However, unlike previous years where there was a positive relationship between movements in the iron ore price and BHP and RIO's stock prices, 2017 was an extremely odd year. The share price of BHP and RIO rose 18% and 27% respectively despite the A$ iron ore price falling 15%. Given such a large disconnect, their elevated share prices are implying a strong outlook for iron ore prices. Time will tell whether this will happen, but we believe the odds are against it.

China accounts for around two-thirds of world iron ore demand, so any changes in the country's marginal demand has a profound impact on iron ore prices. Unfortunately for the resource bulls we believe the conditions that led to a significant increase in iron ore prices in CY2016 are unlikely to be repeated. To stave off a recession in 2015, the Chinese Government implemented enormous stimulatory measures. Its fiscal expenditure growth rate jumped from 10% in the prior year to 18% (equivalent to a 16 trillion RMB injection) and monetary policy was aggressively eased (interest rates dropped from 6% to 4.35%). The stimulus led to the tail winds of strong infrastructure spend and property construction, which underpinned steel demand, resulting in a sharp iron ore price rebound in 2016.

Backing up the enormous fiscal stimulus of 2015, the Chinese government did not disappoint when they announced their 13th five-year plan (2016 to 2020) to spend 13.4 trillion RMB on more than 300 projects on roads, railways, waterways, and airports. Their flagship megaprojects include:

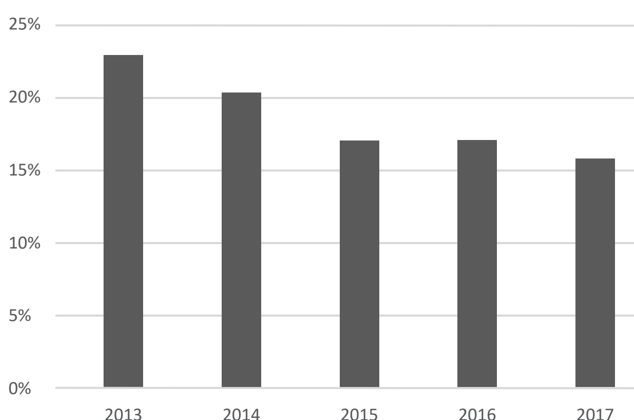
i. Belt and Road Initiative: the modern-day equivalent of the old Silk Road trade route to connect China to more than 65 countries across Asia, Europe, the Middle East, and Africa.
ii. Jing-Jin-Ji development: to create a megalopolis connecting Beijing, Tianjin, and Hebei with significant

transport infrastructure so that 130 million people within that region can move around with ease.

iii. Yangtze River Economic Belt: to strengthen logistics and transport infrastructure that covers 11 provinces including Shanghai. The region accommodates almost half of China's population and generates more than 40% of China's GDP.

While the large infrastructure spend is impressive, it is important to note that the growth rate has decelerated from the previous five-year plan and has been relatively steady in recent years. Stable growth rates in infrastructure spend means it does not create extra marginal demand for iron ore.

Chart 6. Chinese infrastructure fixed asset investment yearly growth rate



Source: Vertium, National Bureau of Statistics of China

The steady infrastructure spend since the start of the 13th five-year plan reflects recognition within the Chinese government that debt is unsustainably growing faster than GDP. The Bank of International Settlements estimates that China has a total debt to GDP ratio of 256%. Over the last two years, China has attempted to control their debt binge by maintaining their budget deficit to around 3% of GDP. For 2018, authorities have recently announced that they will be maintaining the same budget deficit as prior years. Hence, for the foreseeable future infrastructure spend is expected to remain steady.

While we do not think Chinese infrastructure spend will add more to incremental demand for iron ore, we have concern about recent cyclical weakness in property construction. The monetary stimulus implemented in 2015 had the unintended consequences of stoking a property bubble, which China's richest man, Wang Jianlin, in 2016 declared was the "biggest bubble in history". As we debate about how to cool Australian house prices, in China there are now strong policies to curb property speculation. This includes the requirement that second home buyers put up at least half of the purchase price in equity, and home resales are banned within two to three years of purchase.

Strict macroprudential policies and recent increases in interest rates have led to property prices cooling and a fall in property construction. While many commentators cite current strong steel margins to underpin iron price demand it ignores the fact that steel producers are selling into a weaker real estate construction market. The latest yearly growth rate of floor space under construction is now running at -6%. The cyclical nature of Chinese property construction means that this large segment of the Chinese economy has a significant impact on the marginal demand for steel and indirectly iron ore. Hence, it has a strong influence on the iron ore price.

Chart 7. USD Iron Ore price versus Chinese floor space under construction yearly growth rate (3mma)

Source: Vertium, National Bureau of Statistics of China, Iress

China is now running hard to stand still. There is no longer a cyclical uptick in property construction. With share prices of iron-ore related companies implying higher commodity prices there is a disconnect between perception and the reality of what is happening in China. Accordingly, we remain cautious on iron ore related companies.

Stock Commentary

Clydesdale Bank (CYB) and ANZ Bank (ANZ)

CYB (12.7% quarterly return) has been a core position in the Fund since inception because we are attracted to its excess capital position. As described in our previous quarterly, CYB is the most overcapitalised of the listed UK bank peers. When CYB transitions to a more capital efficient model, called the Internal Ratings Based approach, by 2019 the company will be able to return a

significant amount of its excess capital to shareholders. We estimate that CYB has about £500 million in excess capital (A$1 per share; 17% of market capitalisation).

Like CYB, our interest in ANZ (-0.2% quarterly return) is largely due to its excess capital position. Over the quarter we established a new position in ANZ after their FY17 results when the market failed to recognise the value of their excess capital. Unlike the other major banks, ANZ is the only one that has significant excess capital above the APRA imposed 'unquestionably strong' 10.5% Common Equity Tier 1 (CET1) ratio.

Table 2. Major banks proforma capital ratios and surplus / deficit capital

	ANZ	CBA	WBC	NAB
CET1 Capital ($bn)	44	47	43	38
Risk Weighted Assets ($bn)	391	437	404	382
CET1 Ratio	12.1%	10.8%	10.6%	10.1%
APRA Target	10.5%	10.5%	10.5%	10.5%
Surplus / Deficit Capital	1.6%	0.3%	0.1%	-0.4%
Surplus / Deficit Capital ($bn)	6.3	1.1	0.6	-1.7
% of Market Capitalisation	7%	1%	1%	-2%

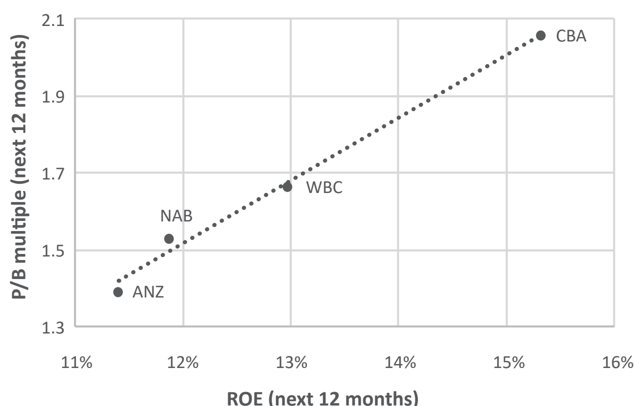
Source: Vertium, Iress, ANZ, CBA, NAB, WBC

Under new leadership, ANZ in two years has reversed the 8-year Asian growth strategy that previous management pursued. The sale of the Asian assets has been part of a broader restructure of the group in which fifteen businesses have been divested. ANZ has also pulled back from its riskier Institutional lending business by a quarter over the same timeframe.

Even though asset sales will result in about $300 million less profit, that will be more than offset by over $6 billion in excess capital released. In December, ANZ announced a $1.5 billion on-market share buyback after receiving the proceeds from the Shanghai Rural Commercial Bank sale. This is just the beginning of ANZ's capital management program. The company has indicated that excess capital will be returned to shareholders as proceeds from other asset sales are received over FY18/19. On our estimates, if all excess capital was used to buy shares at current prices it would add more than 7% to earnings per share.

Overall, the quality of ANZ's business has improved dramatically – the business has been simplified, reducing operating risk, and it has a capital position head and shoulders above its peers. In the long term, ANZ's return on equity should also improve as capital is allocated to its profitable domestic franchise rather than riskier foreign ventures. Given that ANZ has the lowest return on equity (ROE) of the major banks it has the greatest scope for improvement. Hence, ANZ has the greatest potential for a valuation rerating over the long term.

Chart 8. Major banks' price to book equity multiples versus return on equity



Source: Vertium, Factset

Retail REITs and Westfield Corporation (WFD)

Readers of our monthly reports will have noticed our significant REIT sector exposure (especially retail REITs) since inception. The false narrative about Amazon leading to the death of shopping centres has crushed retail REIT's share prices (read our article "Weed out the False Narrative" for further discussion). Some REITs have recently traded below their Net Tangible Assets (NTA), which has not been seen since 2012. Over the course of the year, we have used this opportunity to build positions across several retail REITs including WFD (+21.1% quarterly return).

In December, Unibail-Rodamco (UL) announced a friendly takeover of WFD. The cash and scrip offer consideration is equivalent to US$7.55 per share (or A$10.01 per share), which implies a 55% premium to NTA. When we bought WFD around A$8 per share it was reasonably priced, but certainly no bargain given that its NTA was about US$4.84 per share (A$6.45 per share). Hence our position was a modest 2% of the portfolio. We were patiently waiting to build a high conviction position, where we ideally would like to buy the shares at NTA and thus get the development book for free. Alas, the market was not bearish enough for this to happen.

Our WFD investment thesis was based on the view that the market was underappreciating its large development book, which will drive its NTA significantly higher in future years. As a percentage of WFD's book equity of US$10 billion, development spend is extremely large at 49%.

Table 3. Westfield Corporation's development projects

Shopping Centre	WFD share (US$ millions)
Century City (Los Angeles, US)	1,000
UTC (San Diego, US)	300
Westfield London (UK)	350
Valley Fair (San Jose, US)	550
World Trade Center Tower 3 (New York, US)	300
Milan (Italy)	1,400
Topanga (Los Angeles, US)	165
Croydon (London, UK)	817
Total Development Spend	**4,882**
% of Current Book Equity	**49%**

Source: Vertium, Westfield Corporation

Century City, UTC and Westfield London were going to drive near term NTA growth as they were due for completion within the next few months. Over the long term, we estimate that WFD's development spend would have helped increased its current NTA from US$4.84 (US$6.45) to about US$8.10 (A$10.80 per share) by 2024. Based on the takeover metrics, UL has brought forward WFD's future value without the execution risk, hence we believe WFD is now fully valued.

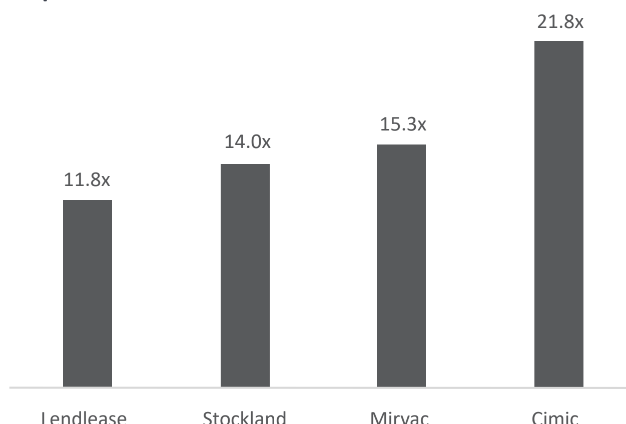
With WFD euphoria affecting most of the REIT sector, we took profits on some of our REIT exposures, when their share prices temporarily disconnected from their fundamentals.

Lendlease (LLC)

Our holding in LLC performed poorly delivering -8.8% return for the quarter. The company scored an own goal by reporting problems with a small number of engineering projects. Following the share price weakness, we increased the position as we believe the market has overreacted to the negative news.

LLC is a diversified conglomerate with three divisions – development (40% of FY17 profit), investments (36% of FY17 profit), and construction (24% of FY17 profit). Compared to its peers, LLC looks cheap based on PE multiples.

Chart 9. PE multiples (next 12 months) of Lendlease and its peers



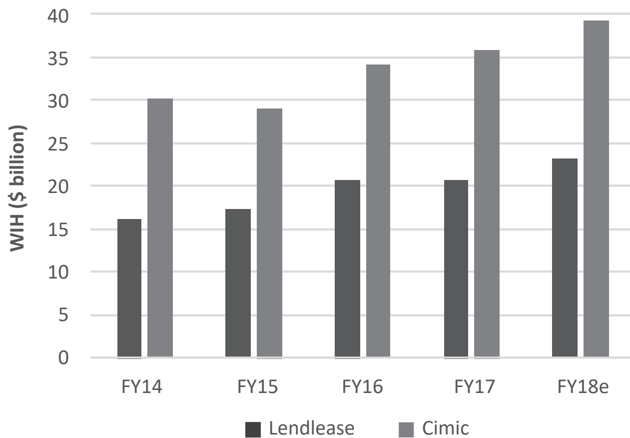
Source: Vertium, Factset

Given LLC has different divisions with distinct risk and return profiles we value each individually and use a 'sum of parts' using asset-based valuations where possible to value the entire group. The sum of parts is broken into two components (i) development and investments, and (ii) construction.

First, LLC states that its development and investment division has about $6.3 billion in invested capital. When the FY18 group net debt of $433 million is subtracted off the invested capital, the implied value of the development and investment division is worth about $10 per share ($5.9 billion in book equity). LLC's closest peers for its development and investment division are real estate trusts that have significant residential development earnings, such as Stockland (SGP; 7.2% quarterly return) and Mirvac (MGR; 4.8% quarterly return) which both trade on 1.1x book equity. Despite a growing development book and a healthy funds management business, we conservatively value LLC's development and investment divisions at 1x book equity. At about two-thirds of LLC's $16 share price, this is the bedrock of the company's total value.

Subtracting this from the share price implies that the construction business is worth about $6 per share (or $3.5 billion). The contracting business is capital-light in nature, so our preference is to use an earnings- or revenue-based multiple as a measure of value. The value of the construction business is related to its earnings outlook, which is proxied by its work in hand revenue backlog (WIH). The following chart displays the WIH of LLC and its contracting peer Cimic (CIM; 16.4% quarterly return).

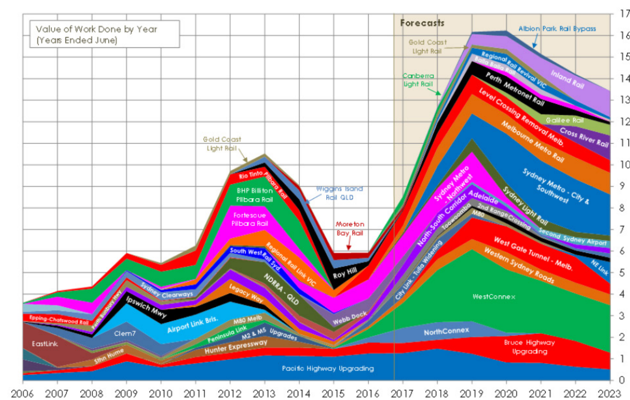
Chart 10. Lendlease and Cimic's work in hand revenue backlog



Source: Vertium, Cimic, Lendlease

Both companies show healthy historical growth in WIH and is expected to grow further given the transport infrastructure boom on the East Coast of Australia.

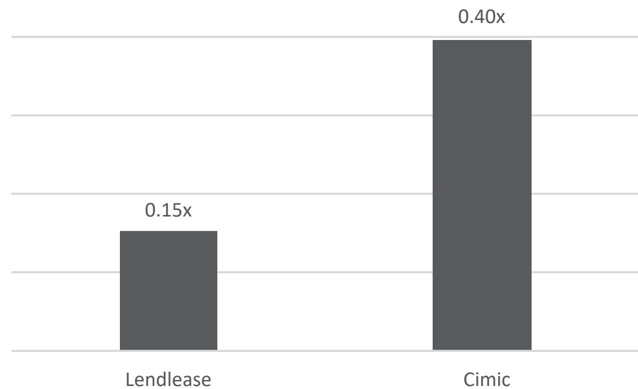
Chart 11. Major Australian transport infrastructure projects



Source: Cimic

When the enterprise value is measured against WIH as a ratio it highlights that LLC construction business is very cheap versus CIM (note that this ratio is a variation to the traditional price to sales ratio. Rather than using the next period revenue we use the total revenue expected from the WIH).

Chart 12. Enterprise value to WIH ratio



Source: Vertium, Factset, Lendlease, Cimic

What about the problematic engineering projects? To put the problems into context, the engineering backlog only represented about 15% (or $3.1 billion) of the total construction backlog in FY17. If you assume a bear case scenario and wipe out the entire engineering construction backlog for projects won prior to FY17, LLC's EV/WIH ratio increases from 0.15x to 0.18x. That hardly moves the dial, so LLC's construction business still looks very cheap.

In summary, while it was disappointing that LLC did not perform well over the quarter from a long-term perspective we believe the market has overreacted to a small hiccup in their construction division. If it remains cheap, LLC is worth more under the ownership of another company that could utilise LLC's undergeared balance sheet, remove its bloated corporate costs and enjoy greater economies of scale.

Concluding Remarks

Our focus on avoiding unnecessary risk has meant that we underperformed the market over the quarter as the market embraced a 'risk-on' attitude and chased the hottest themes. While we are very comfortable with our portfolio we are beginning to see stretched valuations across many stocks in the market. Our approach is to wait patiently for low-risk opportunities rather than to increase the risk of potential capital loss by chasing momentum stocks.

Waiting for the right opportunity is the best way the Fund can 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+

Fund information

Manager Vertium Asset Management	**Inception date** 1 May 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 soft-close and ex-distribution.

#In order of highest to lowest weighting at the end of the reported month.

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