Vertium Equity Income Fund

Fund Update | 31 March 2024

Key Facts

Investment objective

Higher level of income than the Index

Lower volatility and drawdown than the Index

Potential for capital growth over the medium to long term (net of all fees)

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 Panorama | CFS | HUB24

IOOF | Linear | MLC | Netwealth

Oneview | Praemium | MyNorth

Macquarie | Mason Stevens

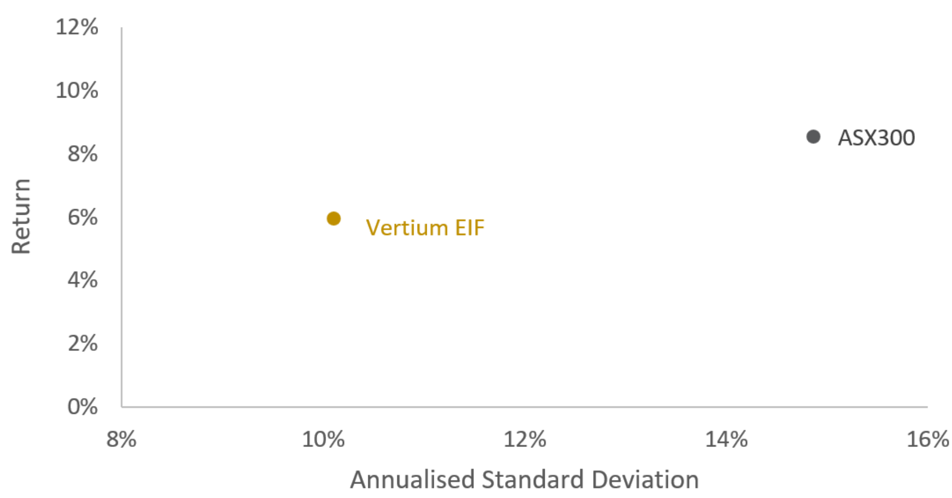
Capital preservation metrics (since inception) ^

	Fund	ASX300
Outperformance frequency in down markets	89%	N/A
Down market capture ratio	63%	1
Beta	0.64	1
Maximum Monthly Drawdown	-13.8%	-20.8%

Performance (%)

	1 Mth	3 Mth	6 Mth	1 Yr	3 Yr pa	5 Yr pa	Since Inc. pa
Income	1.0	1.0	2.1	5.4	5.5	6.2	5.8
Growth	1.6	2.0	5.7	5.3	2.7	1.0	0.2
Fund Total Return	**2.7**	**3.0**	**7.9**	**10.6**	**8.2**	**7.2**	**6.0**
Income	0.7	1.3	2.1	4.4	4.4	4.1	4.2
Growth	2.6	4.1	12.1	10.0	5.0	5.1	4.3
Index Total Return	**3.3**	**5.4**	**14.2**	**14.4**	**9.4**	**9.1**	**8.5**
Fund beta	**N/A**	**N/A**	**N/A**	**0.61**	**0.62**	**0.64**	**0.64**

Return versus risk (since inception)



Portfolio Dashboard

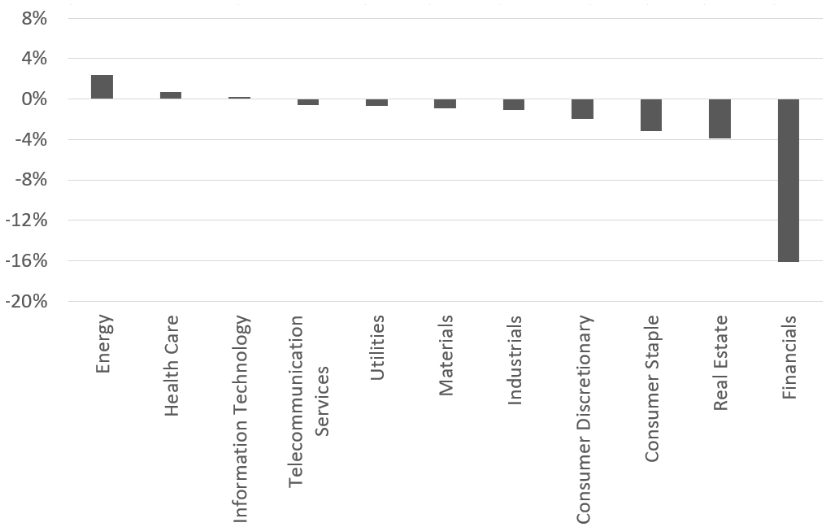
Top 10 holdings	ASX Code
BHP Group	BHP
CSL	CSL
Woodside Energy Group	WDS
QBE Insurance Group	QBE
Orica	ORI
Xero	XRO
Fisher & Paykel Healthcare Corporation	FPH
Fortescue	FMG
Downer EDI	DOW
Goodman Group	GMG

Number of stocks	33

Size exposure	%
Large Cap	49
Mid Cap	24
Small Cap	2
Effective Cash	25

Option exposure	%
Shares	87
Call Options	-10
Put Options	-2
Effective Cash	25

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

FOR MORE INFORMATION, VISIT VERTIUM.COM.AU

Notes: As of 31.08.2021 the calculation of Income and Growth return series has been updated in line with FSC Standard NO. 6. ^Based on monthly data. Past performance is not a reliable indicator of future performance.

Quarterly perspective | **the Markets**

The S&P/ASX 300 Accumulation Index delivered +5.4% return for the March quarter. The best performing sector was Technology (+23.6%) led by Altium +39.9% return, which received a takeover offer during the quarter. The worst performing sector was Materials (-6.3%), with BHP dragging the sector down with losses at -10.0%.

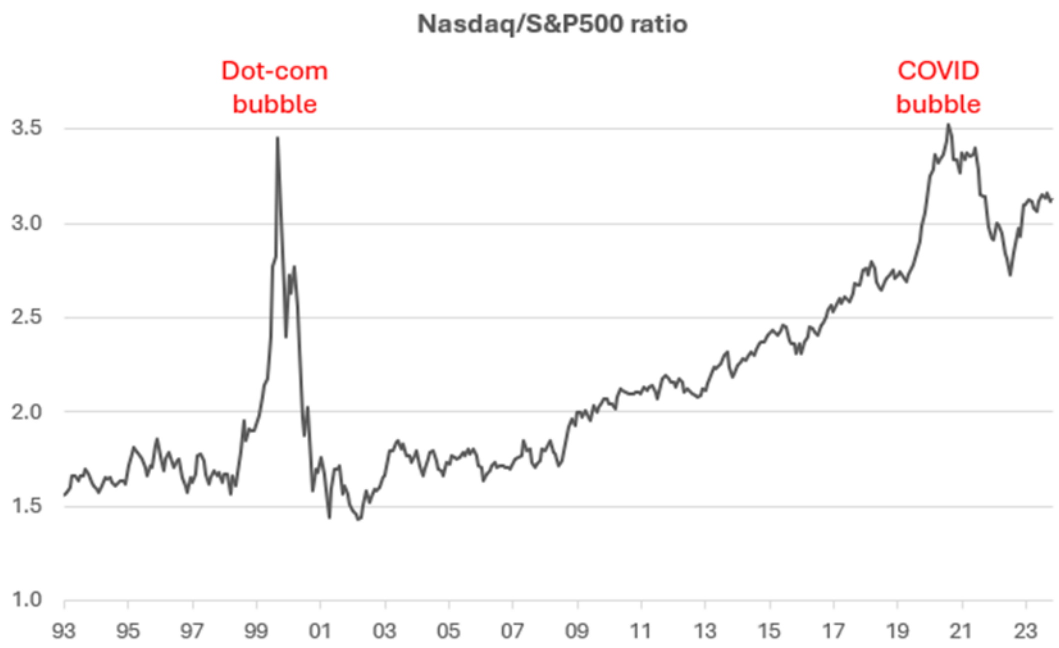
Australia's GDP annual growth rate in Q4 of CY2023 decelerated to 1.5%. The unemployment rate improved to 3.7% in February as the number of people looking for jobs reduced. The annual inflation continued to ease to 4.1% in Q4 of CY2023, primarily driven by a slowdown in goods and services inflation.

Commodity prices presented a mixed picture during the quarter. The iron ore price (-28.4%) retreated from the previous quarter, which highlights the stop-start nature of Chinese stimulus. The copper price remained subdued (+3.0%). The Brent oil price (+12.9%) and the gold price (+8.2%) rose on geopolitical concerns. The Newcastle thermal coal price (-11.8%) continued to falter due to sluggish global growth.

Bubbles and Anti-bubbles

The recent strength of the market rally has sparked concerns about a return of market bubbles. Bubbles are often easy to identify in hindsight because they exhibit exponential price movement compared to a benchmark or fundamental metrics.

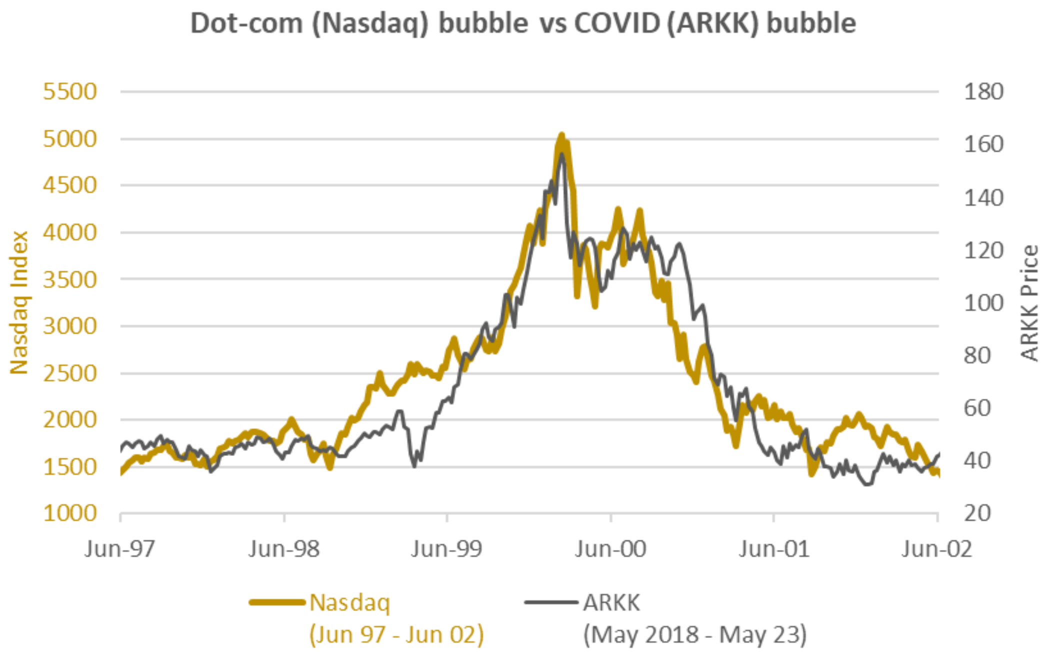
For example, looking at the ratio of the Nasdaq to the S&P 500 reveals two major technology-related bubbles over the past three decades.



Source: FactSet, Vertium

The first was the Dot-com bubble (1998-2000) during the internet's early development. The second was the COVID bubble (2020-2021), which saw a surge in disruptive technology stocks. Interestingly, the ARK Innovation ETF (ARKK), a listed fund heavily invested in disruptive technology stocks, mirrored the Dot-com boom and bust that occurred two decades earlier.

Quarterly perspective | the Markets



Source: FactSet

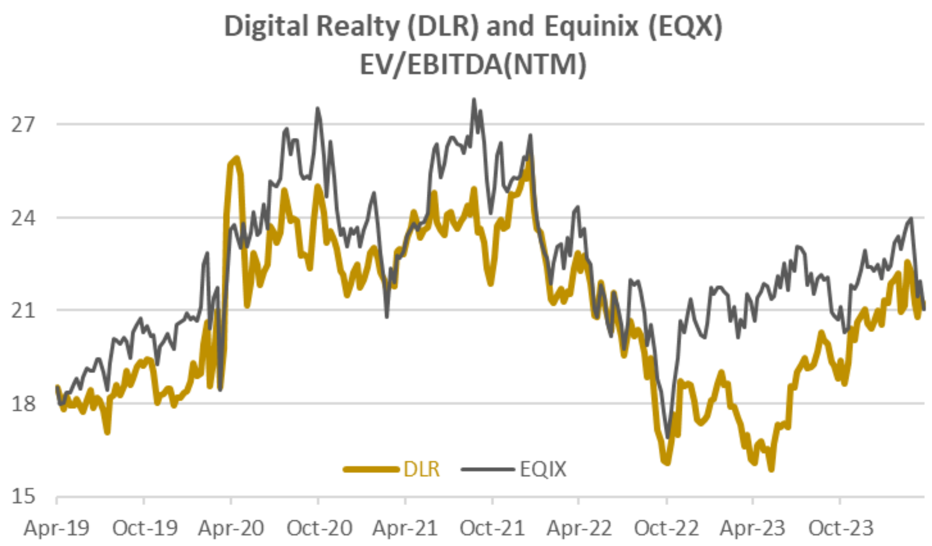
While bubbles are rare, they serve as a reminder that excessive investment flows chasing specific themes can drive stock prices wildly beyond their intrinsic value. With the COVID bubble still fresh in our minds, its serves as a valuable benchmark to identify potential overvaluation and undervaluation.

The recent boom in Artificial Intelligence (AI) boom has captured investor attention, leading to exponential growth in some US stocks. In Australia, opportunities to capitalise on this trend are limited, with Next DC (NXT), a data centre company, being a notable example. Fuelled by AI-related investment flows, NXT's share price has unsurprisingly skyrocketed. However, its valuation multiple has reached stratospheric heights, exceeding even its peak during the COVID bubble.

Source: FactSet

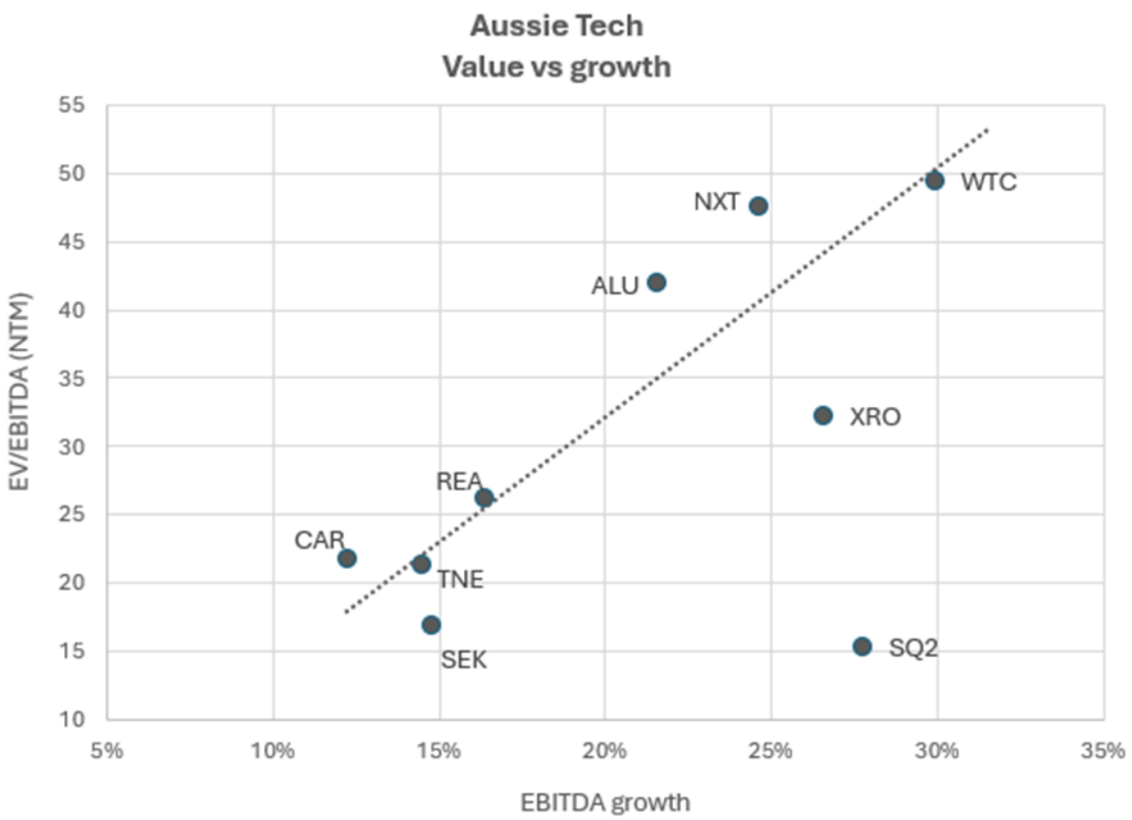
Quarterly perspective | **the Markets**

NXT's data centre peers, Equinix and Digital Realty, have also seen value increases. However, unlike NXT, their valuations haven't reached bubble territory. This is likely because the US offers more AI opportunities, which can more readily absorb the thematic investment flows. As a result, these companies trade below their peaks from the COVID bubble.



Source: FactSet

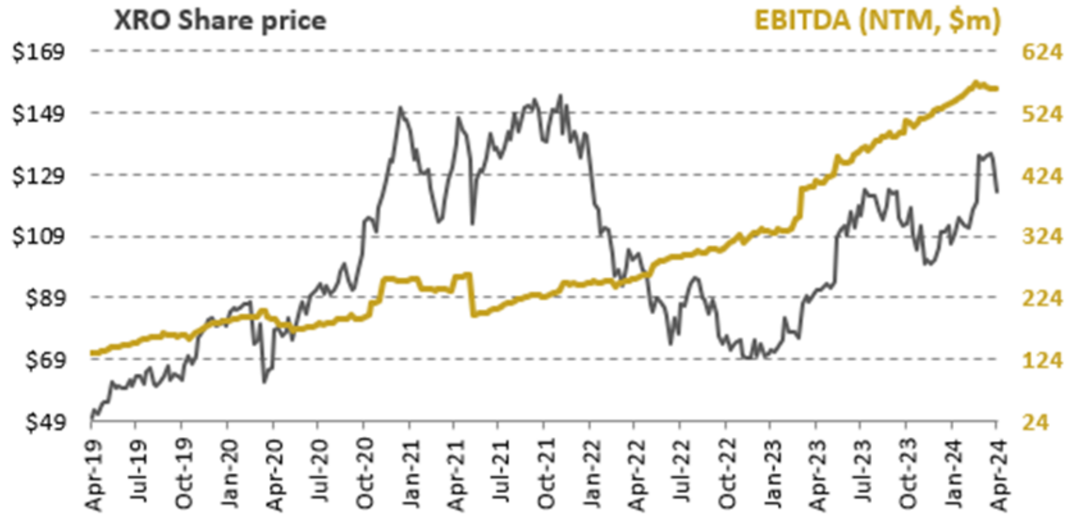
While some stocks seem to be in bubble territory, others are experiencing the opposite phenomenon – “Anti-bubble”. These stocks have depressed valuations despite strong fundamentals because investment flows in the opposite direction are holding back their share price. Xero (XRO) and Block (SQ) are prime examples of anti-bubble stocks as their valuations relative to their growth rates are significantly cheaper than their peers.

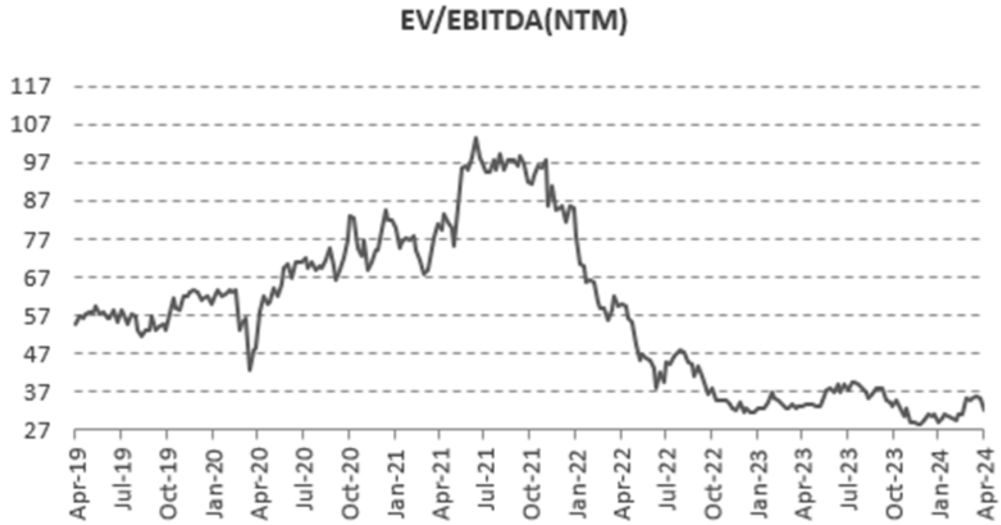


Source: FactSet

Quarterly perspective | the Markets

XRO's earnings have grown considerably, yet its valuation multiple has significantly decreased. At its 2021 bubble peak, the stock traded at a sky-high multiple of 100x EV/EBITDA. Today, that multiple has shrunk by two-thirds!

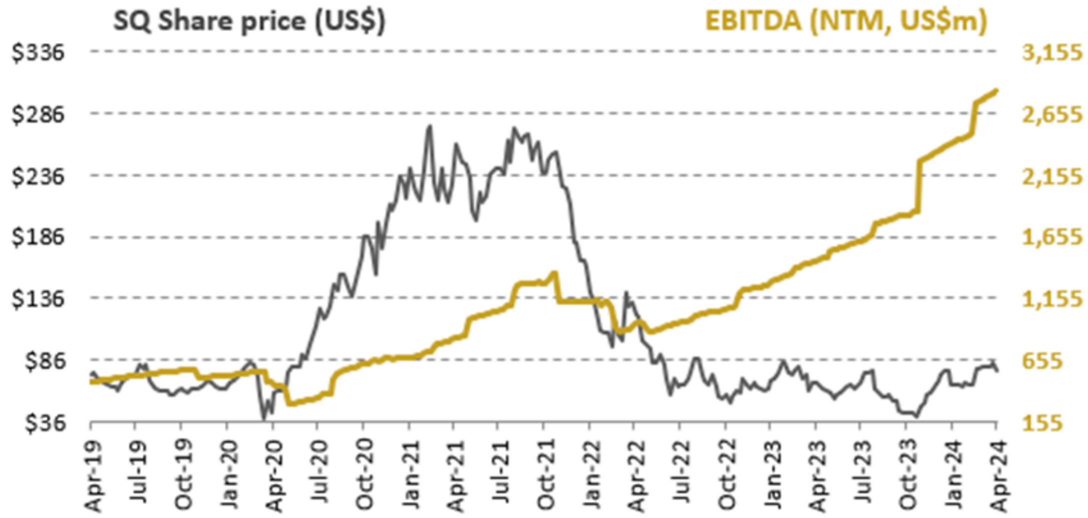


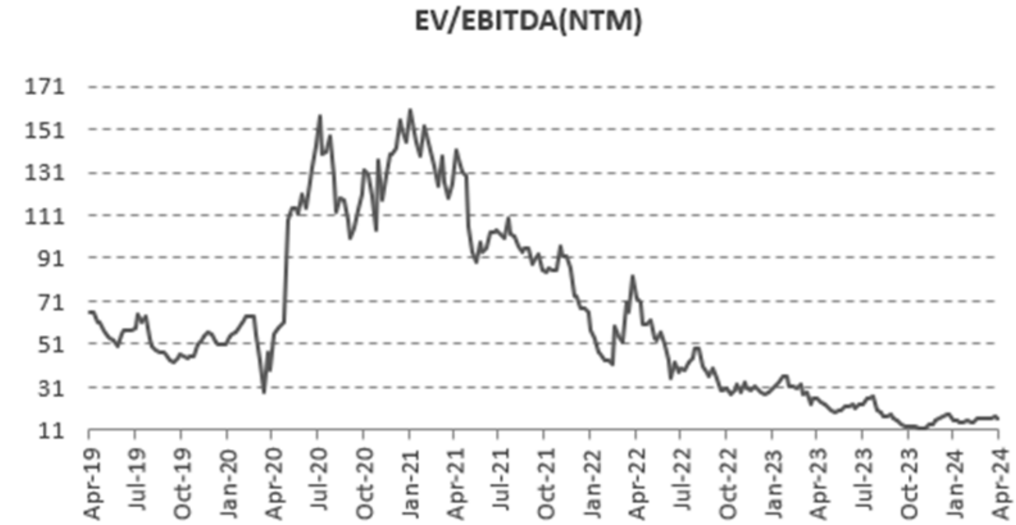


Source: FactSet

SQ's profile is even more dramatic. This company, formerly known as Square that bought Afterpay, traded at a staggering 150x EV/EBITDA during the COVID bubble. Today, its multiple is a mere fraction of that peak.

Quarterly perspective | **the Markets**



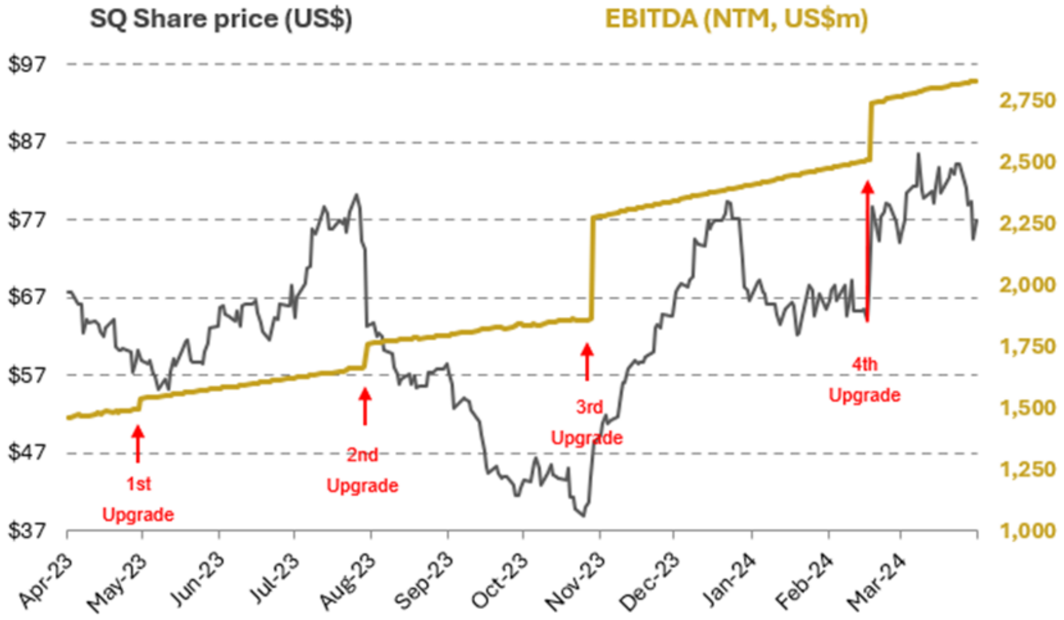


Source: FactSet

Both XRO and SQ share a common theme. They've adopted a "Rule of 40" business model, which seeks to balance growth and profits. This strategy targets a combined revenue growth rate and profit margin of at least 40%. This shift in business model of prioritizing profitable growth over rapid revenue expansion at any cost is impacting their share prices as investor preferences adjust. Some growth-focussed investors who may dislike slowing revenue growth are selling, while some value investors drawn to rising profits are buying. For example, SQ has attracted the attention of deep value investors like Michael Burry, who famously shorted the US housing market before the 2008 Financial Crisis.

Burry, along with many others, has taken notice of the disconnect between Block's rising earnings and its lacklustre share price. Since mid-2023, SQ has consecutively exceeded analyst expectations and raised earnings guidance four times, with its forecast EBITDA nearly doubling over that time.

Quarterly perspective | **the Markets**



Source: FactSet

While the shift in investor focus explains some of SQ's anti-bubble behaviour, there could be another factor at play – ARKK is one of SQ's largest shareholders. During the COVID bubble, massive inflows into ARKK inflated the valuations of many of its holdings. Now, with the bubble burst, ARKK is experiencing significant outflows, forcing them to sell their holdings, putting downward pressure on SQ's share price.

However, ARKK's outflows might be a mere ripple compared to the potential tidal wave of buying that looms on the horizon if SQ is included in the S&P 500. Historically, SQ's lack of profitability disqualified it from inclusion. However, its recent focus on profitability, SQ is a strong candidate for inclusion if it maintains positive GAAP earnings for four consecutive quarters.

Inclusion in the S&P500 would trigger significant buying from index funds, which would place it around the 200th rank in the index based on its current market capitalisation of US$45 billion. The index inclusion may also attract significant investment flows from active managers as there are very few companies in the index trading on a PE multiple of 21x with an expected growth rate of 29%. While SQ's current situation presents an anti-bubble opportunity, only time will tell if another "feeding frenzy" could inflate it into a new bubble.

In conclusion, the recent market surge has reignited concerns about potential stock market bubbles. Identifying these bubbles can be challenging, but historical comparisons and a focus on valuations relative to fundamentals can provide valuable insights. While some stocks like NXT exhibit characteristics of a bubble due to excessive investor enthusiasm, others like XRO and SQ2 present an intriguing "anti-bubble" scenario. Their strong fundamentals are overshadowed by a mix shift in investor preferences. Ultimately, understanding investment flows in both thematic trends and individual company fundamentals will help distinguish between bubbles fuelled by speculation and anti-bubbles harbouring hidden value.

Quarterly perspective | **the Portfolio**

The Vertium Equity Income Fund achieved a total net return of +3.0% for the March quarter. The Fund paid a 1 cent per unit distribution for the quarter, in line with its commitment to providing investors with a higher income return than the market. The Fund's focus on capital preservation, reflected in its low annual portfolio beta of 0.61, provided insurance against 40% of the market's volatility.

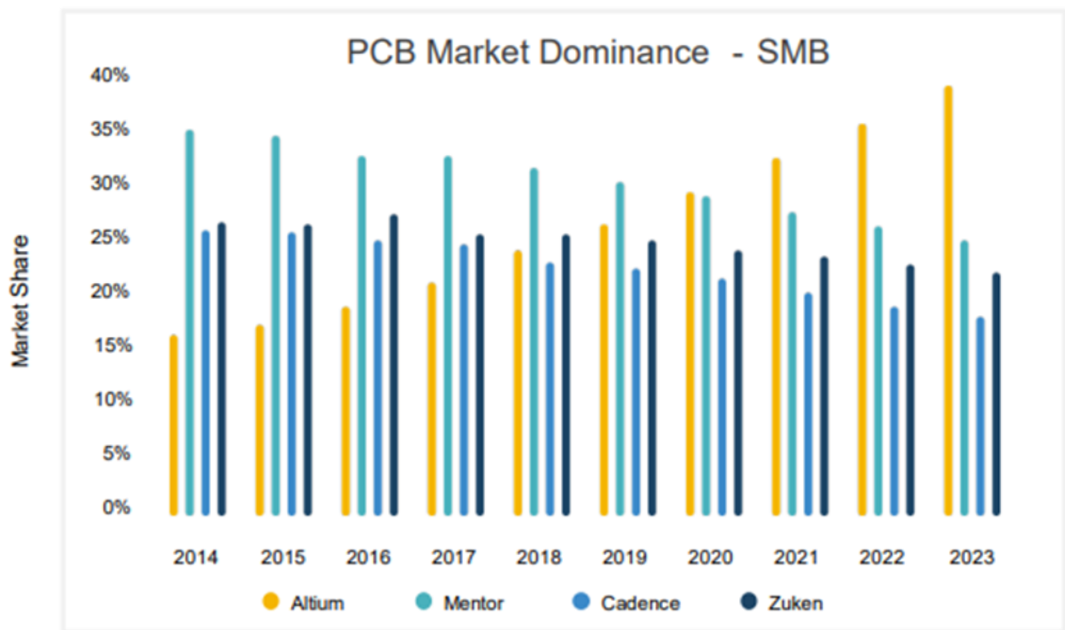
Key contributors to performance over the quarter were mixed. The Fund had a very successful February reporting season as it owned Downer EDI (DOW), Reliance Worldwide (RWC), Block (SQ2), and Xero (XRO), which delivered significant positive earnings revisions, while largely avoiding most of those with earnings downgrades.

Largest earnings revisions (ASX100) in February 2024 reporting season

Best weekly change EPS NTM				Worst weekly change EPS NTM			
Industrials		Resources		Industrials		Resources	
REH	15%	WDS	7%	SEK	-5%	LYC	-10%
A2M	12%			ORA	-8%	NEM	-11%
AMP	11%			SHL	-10%	PLS	-16%
DOW	11%			LLC	-13%	LTM	-18%
SVW	9%			NEC	-13%	ILU	-28%
RWC	8%					IGO	-33%
SQ2	7%					LTR	-347%
VUK	7%						
JBH	6%						
XRO	6%						
COH	5%						

Source: FactSet

The Fund also benefited from its investment in Altium (ALU) following the acquisition announcement by Renesas in February. ALU is a leader in design software for printed circuit boards and has steadily grown their market share, particularly among small medium-sized businesses.



Source: Altium investor day presentation, November 2023

Quarterly perspective | the Portfolio

Since 2019, ALU expanded into the larger Enterprise customer segment. This move increased their total potential market by 60%. The Fund saw an opportunity because the market wasn't fully recognizing ALU's recent expansion. Essentially, analyst forecasts for ALU's growth were stuck at the same levels as five years ago, overlooking this significant market expansion.

Negative contributors to relative performance came from our low weighting in banks, particularly Commonwealth Bank (CBA). While there are emerging signs of home loan volumes recovering, it has not translated into higher forecast earnings as industry competition remains elevated. Despite this lacklustre outlook, bank share prices have risen significantly.

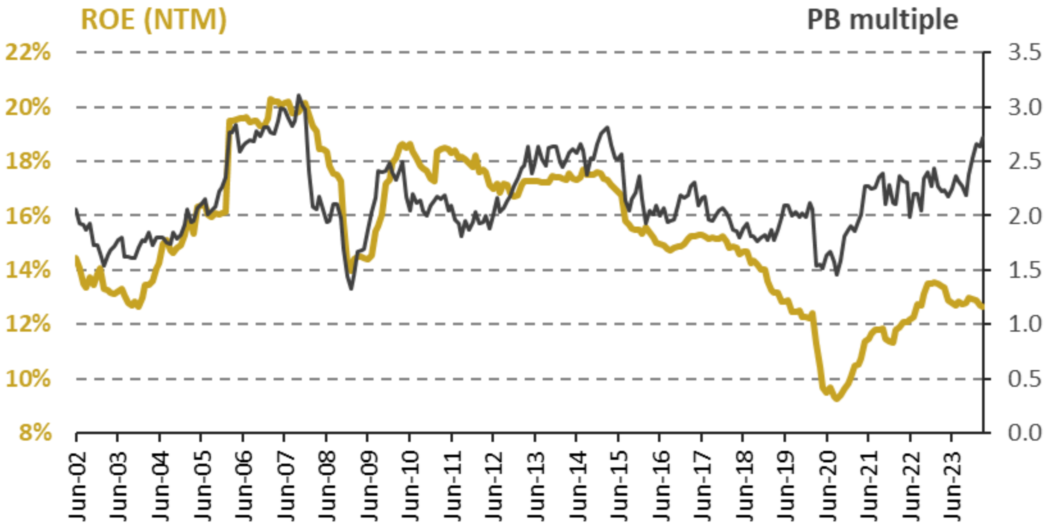
CBA stands out as a prime example of this disconnect. It currently boasts the highest PE ratio among global banks, even exceeding its own historical highs over the past twenty years. Normally, a company's stock price is anchored by its earnings. However, CBA's current valuation seems to be defying this basic principle.

Source: FactSet

Before the 2008 financial crisis, things were booming for CBA. Their earnings were growing at impressive double-digit rates, fuelled by a hot housing market. This justified their PE ratio of around 15x back then. Today, the picture is quite different. CBA's earnings growth is expected to be sluggish, hovering in the low single digits – a far cry from a boom. Yet, its PE ratio has ballooned to a staggering 21x.

Quarterly perspective | **the Portfolio**

High valuations can sometimes reflect a strong, high-performing business. A company's return on equity (ROE) is a good indicator of this. In the lead-up to the crisis, CBA boasted a healthy ROE of 20%, which helped justify their higher price-to-book (PB) ratio at the time. However, today's picture is less rosy. CBA's ROE has significantly declined to around 13%, suggesting a decrease in underlying business quality. Yet, their valuation remains inflated, priced as if they were still a high quality company.



Source: FactSet

CBA's stock price appears to be disconnected from its current profitability. This situation where high valuations meet low or low-quality earnings growth is typically a recipe for trouble.

Another detractor to performance this quarter was the Fund's investment in Domino's Pizza (DMP). DMP exemplified the boom-and-bust cycle of some companies during the pandemic. DMP thrived during the lockdowns as a "COVID Winner" with booming takeaway sales. However, as economies reopened, they became a "Reopening Loser" as it struggled with product pricing and margins when inflation spiked. Following their earnings decline, we saw early signs of a recovery in Australia. This suggested the makings of a successful turnaround.

Same store sales growth

	FY23	First 7 weeks of FY24	First 16 weeks of FY24
Europe	1.9%	6.6%	3.8%
Asia	-5.7%	-7.8%	-6.8%
ANZ	1.1%	6.6%	7.8%

Early signs of accelerating sales

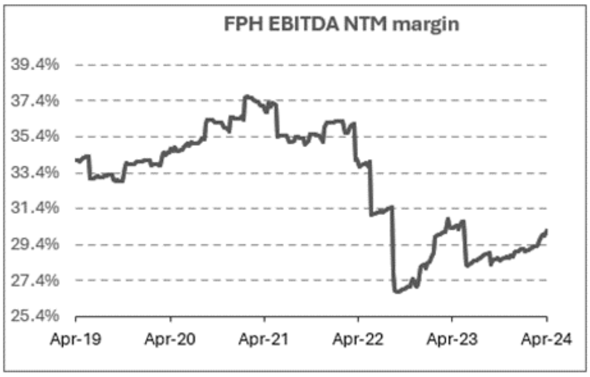
Source: Company accounts and presentations

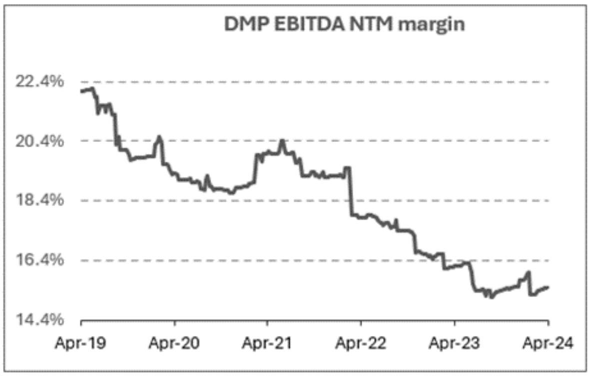
Unfortunately, the timing of our investment proved to be off. DMP unexpectedly downgraded earnings in January, before the official reporting season. While our core investment for DMP's Australian operations remained sound, the situation in DMP's international operations proved more complex.

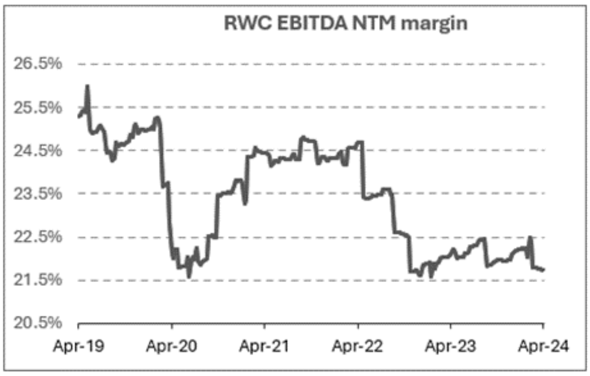
Quarterly perspective | **the Portfolio**

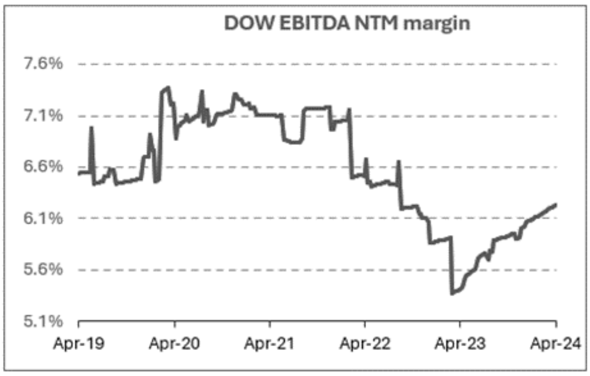
We were aware of potential challenges in Japan and France, but an unforeseen issue emerged – a boycott by Muslim Malaysians of American brands due to the Israeli-Palestinian conflict, negatively impacted DMP's Asian operations. To manage risk, the Fund reduced its DMP position but continues to monitor their turnaround progress.

Turnarounds plays, where companies are attempting to recover profitability, can be attractive investments. The Fund currently holds positions in four such companies: Domino's Pizza (DMP), Fisher and Paykel Healthcare (FPH), Reliance Worldwide (RWC), and Downer EDI (DOW). They all share a common theme of having depressed profit margins.







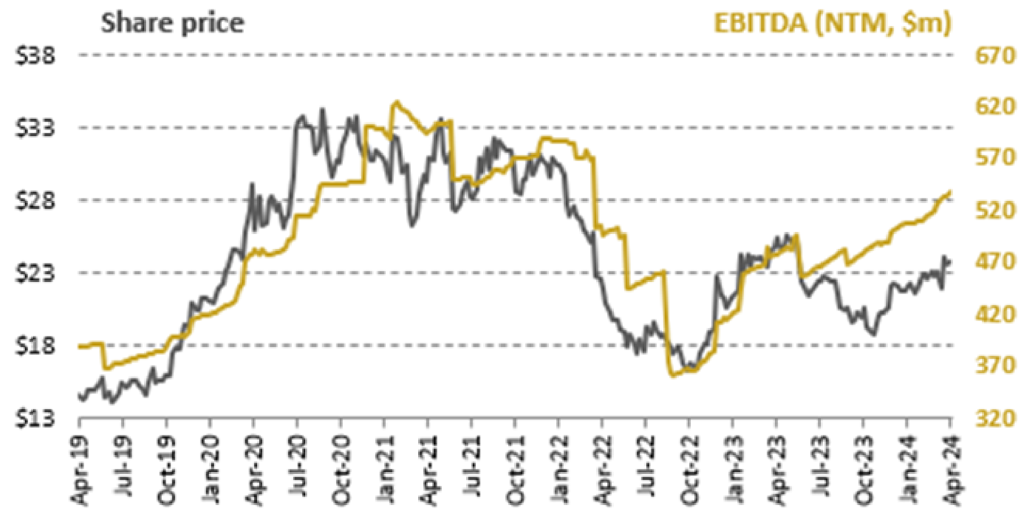


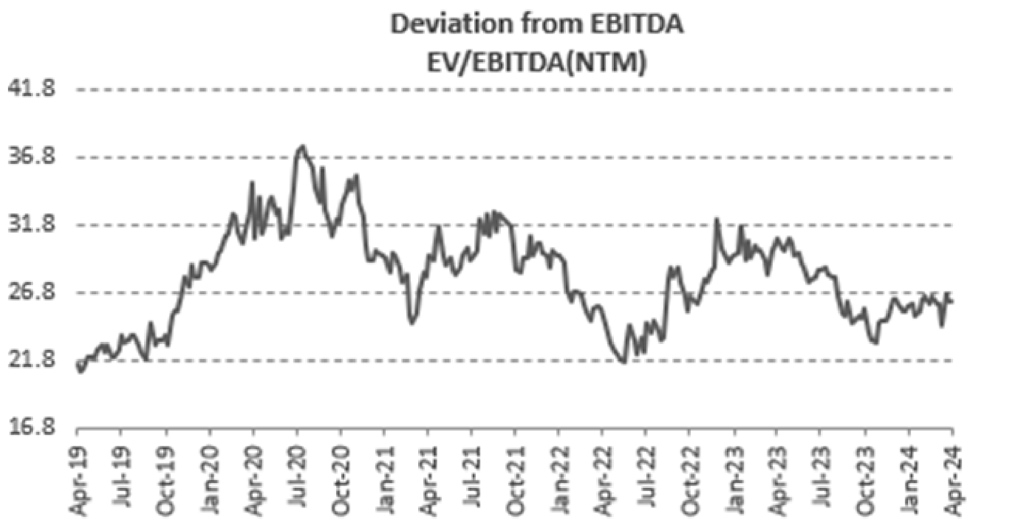
Source: FactSet

The key to success in turnaround investing lies in understanding long term value and timing. Our investment in DMP, while aiming to capitalise on a potential recovery, proved too early. Conversely, our investment in FPH appears to be on track, as evidenced by their recent earnings upgrade in March.

FPH, a leading manufacturer of respiratory products for home and hospitals, mirrored Domino's Pizza's experience. They benefited as a "COVID winner" with hospitals stockpiling ventilators during the pandemic. However, as the pandemic subsided, FPH was a “reopening loser” when hospitals reduced their inventory. Forecast earnings collapsed in late 2022 and then began to recover.

Quarterly perspective | **the Portfolio**





Source: FactSet

The Fund did not buy FPH on its lows when earnings was under pressure and only initiated a position when the turnaround was in place. However, the investment was still very compelling because we believe consensus forecasts for FPH's profit margins are too low for the near future.

While analysts have forecast some margin recovery, their timeline seem overly cautious. The main reason for FPH's depressed margins – supply chain disruptions – are likely temporary. Additionally, FPH had made strategic investments in expanding its sales team to launch new products. While this can initially depress margins, it boosts future sales and ultimately leading to margin expansion. We believe these factors would lead to a rebound in FPH's margins to their pre-pandemic levels. The recent earnings upgrade confirmed our confidence in FPH's turnaround potential.

Concluding Remarks

The Fund remains disciplined in its approach to identifying stocks disconnected from their fundamentals. In an uncertain environment of high interest rates and potential earnings risks, capital preservation is important. As always, the Fund is designed to deliver a balanced outcome of higher income than the market, capital preservation in falling markets and a reasonable total return over time.

We are grateful for managing your capital and thank you for your support.