Wheelhouse Global Equity Income Fund

Monthly performance update

March 2021 – Wholesale investors only

Investment Grade

Zenith Investment Partners Recommended

Performance

	1 month	3 months	6 months	1 year	3 years p.a.	Since inception p.a.
Income	1.93%	1.93%	3.85%	7.61%	8.10%	7.35%
Growth	2.11%	2.15%	(0.34%)	(4.52%)	0.17%	0.10%
Total Fund return	**4.04%**	**4.09%**	**3.51%**	**3.09%**	**8.28%**	**7.45%**
Benchmark*	**5.09%**	**6.33%**	**12.38%**	**23.55%**	**13.16%**	**11.94%**
Risk (Beta)**	-	-	-	0.48	0.48	0.59

Performance figures are net of fees and expenses. Past performance is not indicative of future performance. Inception date is 26 May 2017.

*Benchmark is the MSCI World ex Australia Index. **Risk is defined as Beta and sourced from Morningstar Direct. A Beta of 1.00 represents equivalent risk to the Benchmark. A minimum of 12 months data is required for this calculation.

Currency impact

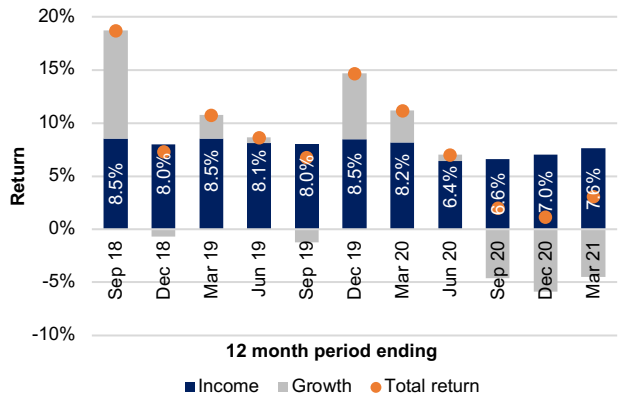
	1m	3m	1y	Inception (pa)
Fund return	**4.04%**	**4.09%**	**3.09%**	**7.45%**
USD impact	1.68%	1.35%	(25.2%)	(0.6%)
USD return	**2.36%**	**2.74%**	**28.28%**	**7.99%**
USD benchmark	3.39%	4.95%	53.75%	12.49%
USD capture	*70%*	*55%*	*53%*	*64%*

Source: Wheelhouse

Income and protection

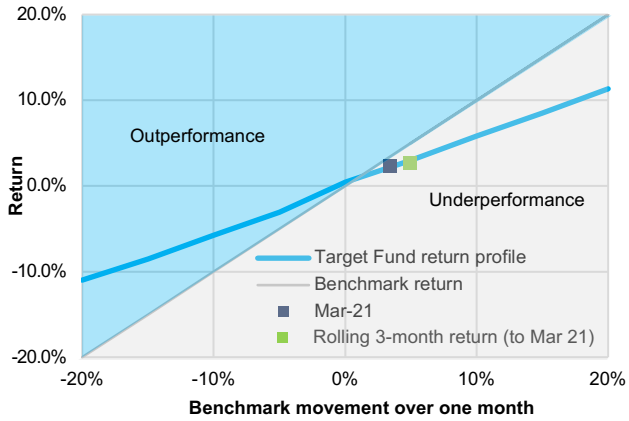
The strategy's high-income generation and active tail risk program are designed to lower risk and deliver equity returns with a smoother, more retiree-friendly return profile. As a result, returns are expected to add relative value in weak and low-growth markets, and to drag in more positive markets. We assess this return profile in USD to strip out the influence of the AUD/USD currency movements.

Income vs total return (12 month rolling)



Source: Wheelhouse

Targeted monthly return profile



Wheelhouse is a retirement solution designed to deliver better investment outcomes to Australian retirees. Our philosophy is based on three pillars:

- investing in global equities as a **growth asset** to address longevity risk;
- shaping returns to be **retiree-friendly** with lower volatility, better capital preservation and consistent income; and
- delivering a **lower cost** solution to help improve outcomes.

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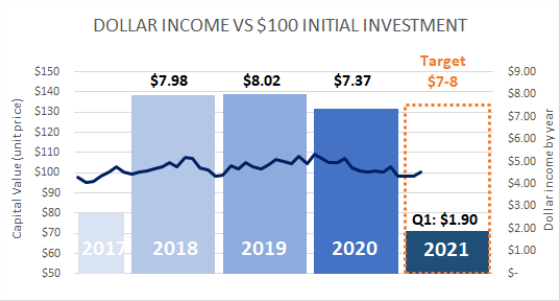
Income generation

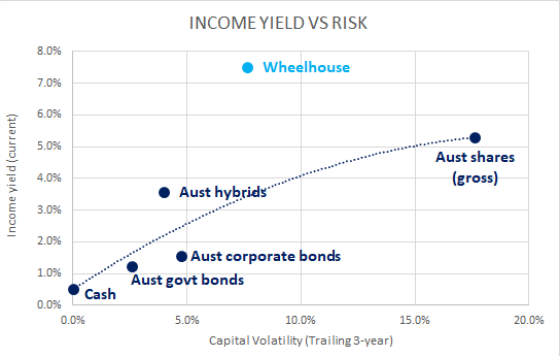
The Fund distributed 1.90c per unit for the March quarter taking the trailing annual income distribution to 7.77c per unit.

This is consistent with the fund objective of 7-8% income yield, while only taking around half the market risk (measured in Beta). This meaningfully lower risk is reflected in a very stable capital value, which has hovered around $1.00 despite all the gyrations in the market since the Wheelhouse Fund inception in May 2017.



Source: Wheelhouse

While the past 12 months have been impacted by the very strong Australian dollar appreciation, over the longer-term the income generation has been entirely funded by real return, leaving a stable capital base that we believe will grow over time.



Source: Wheelhouse, Betashares, Dow Jones S&P Indexes

For income seeking investors, the yield from traditional asset classes remains highly elusive without shifting further out along the risk curve. While at the core of our Global fund is a near fully invested equity portfolio, from a risk perspective the characteristics are much closer to a more traditionally defensive asset class, such as corporate bonds.

We recently wrote about how highly defensive equity strategies may be better placed to deliver higher income yields, with better defensive characteristics than traditional fixed income portfolios in a crisis.

Looking forward, we remain comfortable that a 7-8% income return is achievable whilst assuming only around half of the equity market's risk.

Total return

This month cycles the first anniversary of the bottom of the Coronavirus driven bear market. It is worth spending some time reviewing the 12-month total return of the fund during the post pandemic recovery, as optically the returns may be a little difficult to decipher given the strong underlying market rally during this period.

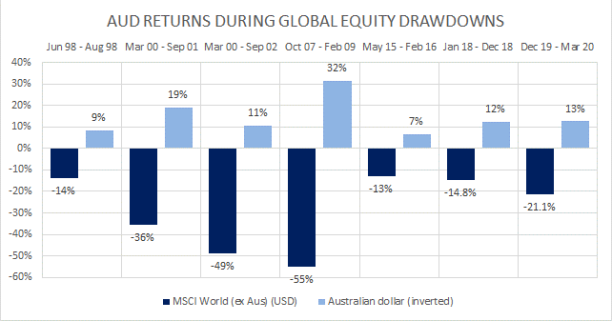
In the sections below we breakout the impact of currency and analyse relative returns on a US dollar basis. This detail may provide some colour that the fund's returns are very much consistent with expectations, despite the extreme movement in both the Australian dollar and markets.

Currency Effect

The strengthening Australian dollar had a major impact on the Fund's returns over the trailing 12 months. While the currency exposure provided meaningful benefit during the pandemic and contributed to the Fund's positive return during the March '20 quarter, the 25% strengthening of the Australian dollar (versus the US dollar) has been a headwind since then.

A rally of this magnitude in such a short period is unusual for the Australian dollar, and we believe the worst of the damage has now been wrought.

Historically being unhedged on currency has proven defensive for Australian investors during periods of market stress. The chart below illustrates the defensive characteristics during every market correction of 10% or more over the past 25 years.



Source: Wheelhouse

We believe this is a valuable characteristic in terms of preserving the capital base during these periods and thus supporting income generation, particularly when other asset classes may be compromised.

While the currency impact has been extreme over the past year, we highlight that since the inception of the Fund the currency impact has been minimal and has simply smoothed the ride over a longer-term horizon.

For this reason, we are comfortable accepting some FX volatility over the short-term.

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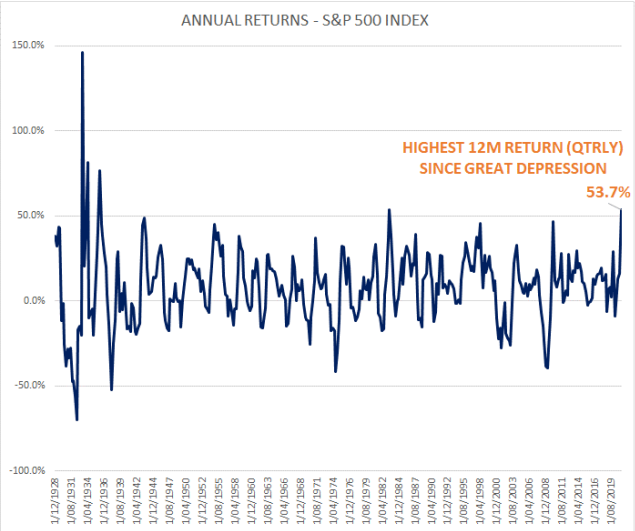
Relative returns

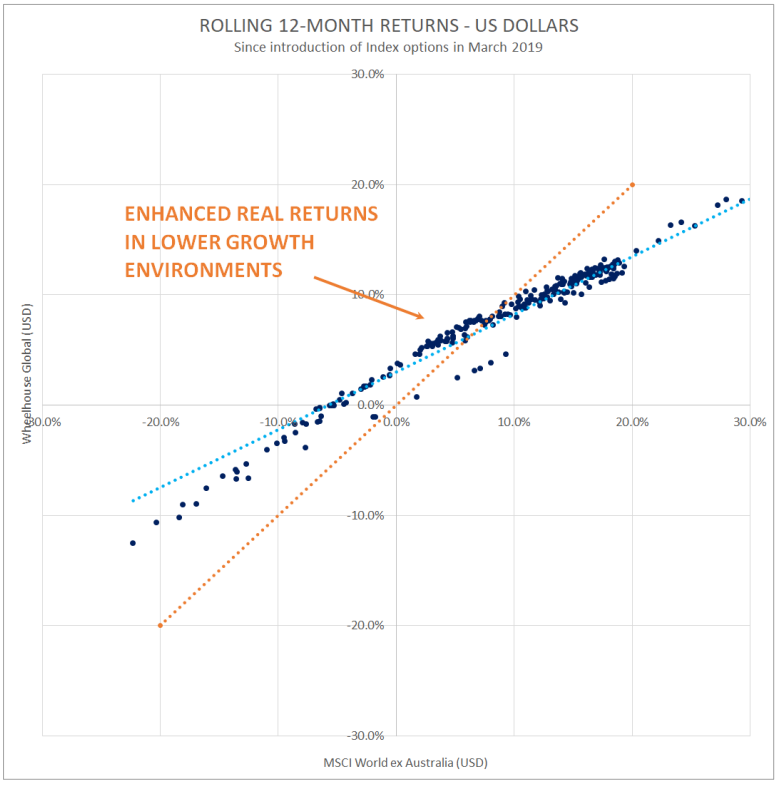
Once the currency impact is removed, relative returns can more clearly be analysed. Due to the meaningfully lower risk assumed by the strategy, we do expect performance will at times meaningfully diverge from the benchmark returns, with underperformance in strong markets, coupled with outperformance in weak and lower growth periods. This 'reshaped' return profile is more closely aligned with an absolute return focused strategy, which makes it far better suited to supporting a regular and reliable 7-8% income stream.

On a US dollar basis, the Global equity benchmark grew over 50% for the year to 31 March, with the S&P 500 rebounding a similar amount off the pandemic lows. For the S&P 500 (which has a longer history), this is the strongest 12-month period of growth since the Great Depression.

As expected in such a strong rally, the fund underperformed the equity benchmark delivering a 28.3% return in US dollars, or a 54% capture of the rally. This capture is very consistent with the average risk assumed during this period which was similar (beta for the last 12 months was 0.48).



Source: Wheelhouse, Bloomberg



Source: Wheelhouse

The trade-off of underperformance in strong markets and outperformance in lower growth and negative markets is well illustrated in the recent rolling 12-month returns of the Fund. In the chart to the left, the advantages of enhanced real returns and improved capital preservation are very evident when market growth is less than +8%. We believe this is a highly valuable return profile when seeking to consistently fund a 7-8% income return, and not erode capital in the process.

When markets transition back to more 'normal' growth rates, or endure a period of lower growth, empirically the strategy has demonstrated it is very well placed to deliver on its income and real return generation objectives. Only 12 months ago the Fund's total return since inception were handily ahead of the equity benchmark. If the past 18 months is any guide, market conditions can (and do) change very quickly, and we are well prepared for this to happen.

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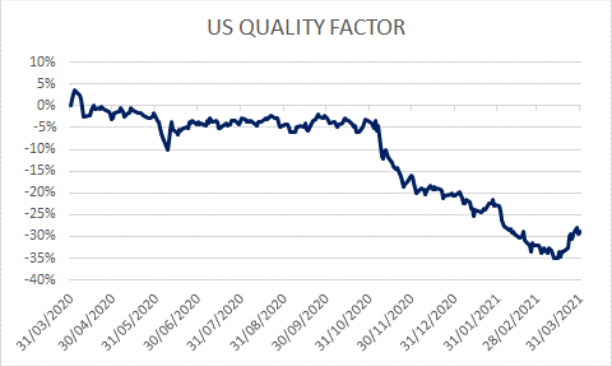
Quality vs Value/Growth

As discussed in the December report, our equity portfolio is largely market neutral from a Value/Growth style perspective, however it does exhibit a perennial Quality and Size (large cap) factor.

Since December the relative underperformance of Quality has continued, with relative returns the past 6 months posting their worst relative return of the last 20 years. The relative returns for the S&P 500 of High vs Low Quality shares are represented below.



Source: Wheelhouse, Bloomberg. Quality factor is estimated as Dow Jones Thematic Long Quality Index less Dow Jones Thematic Short Quality Index.

We believe the rally in Low Quality is one side effect of the global Central Banks liquidity drive and crushing of interest rates, with the perception that there is far less risk for companies with weak balance sheets. As a result, small caps and 'junk' have rallied strongly.

The underperformance of Quality explains for the most part, why our capture of the market rally is a little below our expectations. While we seek to deliver reliability at every step of our investment process, and are non-directional in our market views and generation of income, having any large factors in a portfolio (even good ones, like Quality), can introduce an element of unpredictability. In the past few weeks we have started to see this reverse, and remain comfortable holding the exposure.

Outlook

Comments in March from the US Federal Reserve were designed to placate any market concerns that short-term interest rates would be increasing anytime soon. Alongside the support for an ultra-low interest rate policy, growth expectations for 2021 were also increased to 6.5% for the US.

The combination of continued growth, with ultra-low rates, constitutes one of the most favourable conditions for equity markets and it's fair to say most in the market are universally bullish. This is reflected in surveys of market optimism, which confirm this view.

So where could we go to from here? What's the basis for seeing markets 10% higher? Or 20% higher?

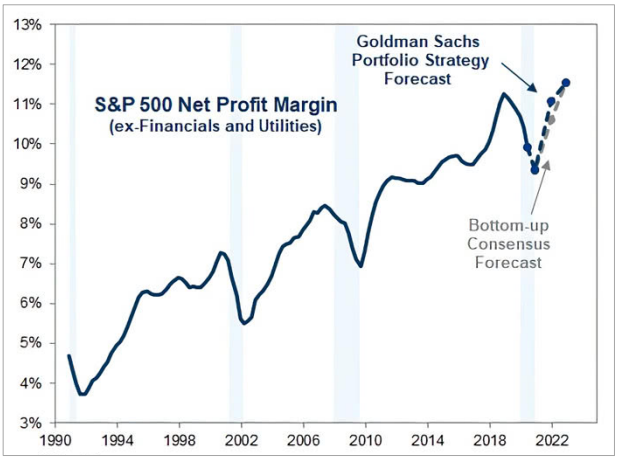
Simplistically, share market levels can be boiled down to two basic drivers:

- the earnings being generated, and
- the valuation multiple that investors are willing to place on those earnings (a PE multiple).

The following two charts set out the last 20 years of profit margins (which drives earnings), along with the valuation multiple that the market was willing to value those earnings at.

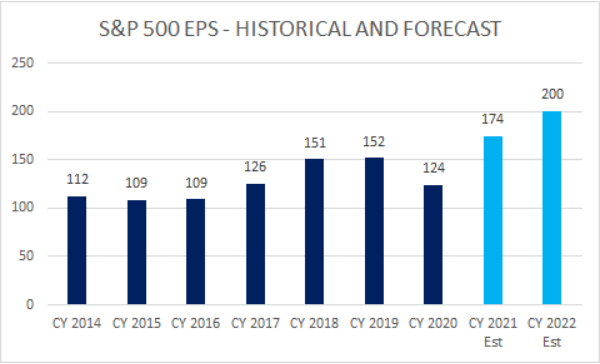
Profitability

Profitability expectations have never been higher, with the Coronavirus impact now well behind market estimates for 2021 and 2022.



Source: Goldman Sachs

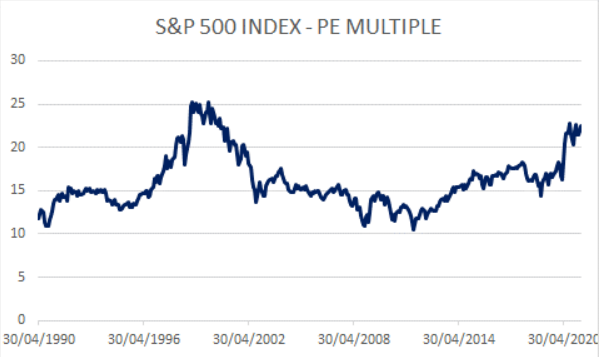
These record profitability levels are reflected in earnings growth expectations (per share) for the S&P500, with the market looking for 14% growth from pre-COVID 2019 to 2021, followed by a further 15% from 2021 to 2022.



Source: Wheelhouse, Bloomberg

Price/ Earnings multiple

Outside of the tech bubble, 12-month forward valuations are at their highest levels in 20 years with the current market PE at over 22x.



Source: Wheelhouse, Bloomberg

Record profitability levels x near record valuation multiples… what could possibly go wrong! The issues below may not become apparent overnight, but in our view will have increasing relevance over the next 12-24 months:

- **Interest rates (Valuation)** – while short-term rates are anchored, gradually rising longer-term interest rates will at some point begin to curtail valuation multiples. At best, they may simply provide some headwind for the market PE multiple to expand higher from here.
- **Interest rates (Earnings)** – the other side-effect of increasing interest rates is the impact on company net profits. While almost immaterial for most corporates at present, a steady increase in interest rates will at some point impact earnings as borrowing costs increase.
- **Tax increases** – Alongside interest rates, tax rates have also steadily fallen. Even a partial reversal of the Trump tax cuts will be felt in the bottom line, providing a further headwind to after-tax earnings and thus EPS growth.

Conclusion

It's difficult not to agree with market consensus in the short term, and that the incredible dovishness of Central banks, combined with reasonable growth, is a very constructive setup for equities. No question.

However, we also need to realise that we are now entering extreme levels in terms of both market valuations, and company profitability/earnings. Markets are already fully factoring in very strong earnings growth, alongside a valuation multiple that we feel has very limited upside.

Following an over 50% market rally in US dollar terms, we believe the value of a highly defensive income strategy, with a greater emphasis on absolute returns, is very well placed for the current market environment.

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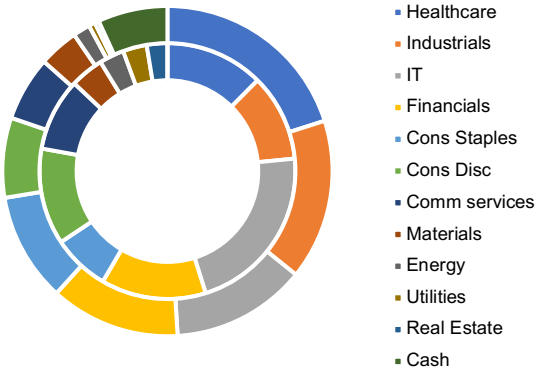
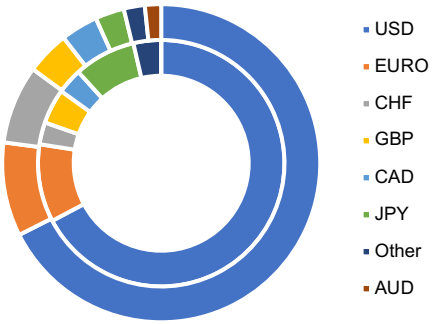
Sector exposure



Currency exposure



Outer circles: Wheelhouse
Inner circles: Benchmark

Contributors	Detractors
GEA Group	Guidewire Software
Polaris	Veeva Systems
Applied Materials	ServiceNow
Dominion Energy	Aspen Technology
Nabtesco	Elekta

How to invest

The Fund is open to investors directly via the PDS, available on our website, or the following platforms.

Platforms
BT Wrap/ Panorama (Super, Wrap, IDPS), Hub24 (Super, IDPS), Netwealth (Super, Wrap, IDPS), Powerwrap (IDPS), Praemium (IDPS), Wealth02 (IDPS).

Contact us

For more information, call (07) 3041 4224 or visit www.wheelhouse-partners.com

Fund at a glance	
APIR Code	BFL3446AU
Benchmark	MSCI World Index (ex-Australia)
Stock range	50 to 100 stocks
Buy/sell	+/- 0.30%
Cash limit	0-10%
Recommended investment period	Medium to longer term (five years plus)
Investment amount	Initial investment minimum: $10,000
Fees and charges	0.79% p.a. (including GST net of reduced input tax credits) of the NAV of the Fund. There is no performance fee.
Inception date	26 May 2017

Note returns are expressed in AUD unless USD is specified, and are net of fees and expenses unless specified as gross.

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