Quarterly Review

Q2 2018

Wenlock Global Fund

Wenlock Global Fund
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Wenlock Global Fund

Performance (net of Fees)	3m	6m	SI
Wenlock Global Fund	+7.63%	+13.21%	+19.64%
MSCI World Net Total Return (AUD)	+5.68%	+6.32%	+15.45%

Highlights

Trade Wars Grip Markets

Earnings continue to surprise to the upside

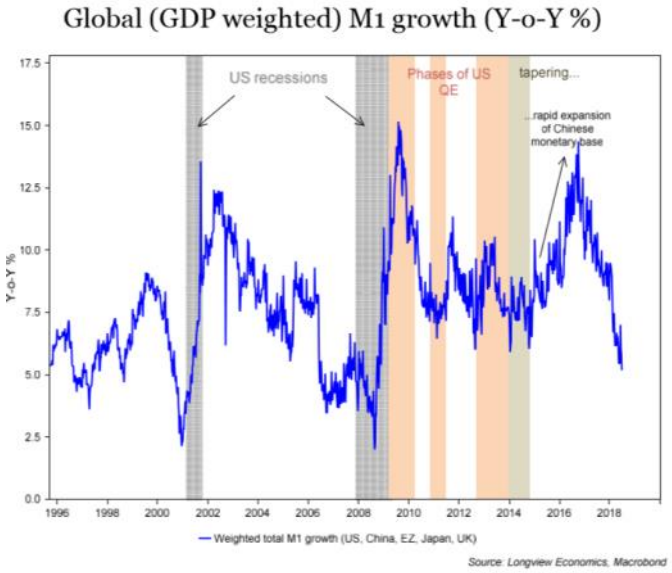
Dear Investors,

In the end, the three months to 30 June 2018 proved to be a relatively positive period for the Fund, outperforming the MSCI World Index (AUD) by +1.94% net of Fees. After a volatile first three months to 2018, we anticipated more of the same for the following 3 month period. To that end, we ensured the Fund employed sufficient protection in the event of further volatility during the ensuing period. One cannot be certain or predict volatility and given the political backdrop, protection remained consistent throughout Q2, at above 70%.

As we have maintained, a rehash of the same or similar news often has little or no impact on markets. So when Donald Trump opines and harangues his latest victims, be it drug companies, state leaders or economic policies, the market appears to have become accustomed to his politicisation.

Amongst all of the political rhetoric we view this as ultimately benefiting US companies in the long term. Of course, the manner and way Trump is going about his policies isn't conducive for the financial markets, however, structurally it provides balance and fairer conditions for US businesses. In the longer term it allows importing countries to build expertise in areas where they lack knowledge, in fact they will be forced to rely less on external knowhow and develop in-country capabilities in the name of national security. Call it tactics or a real shakedown, either way Trump genuinely believes he has the best interest of the US citizens in mind and the US markets seems to more or less agree.

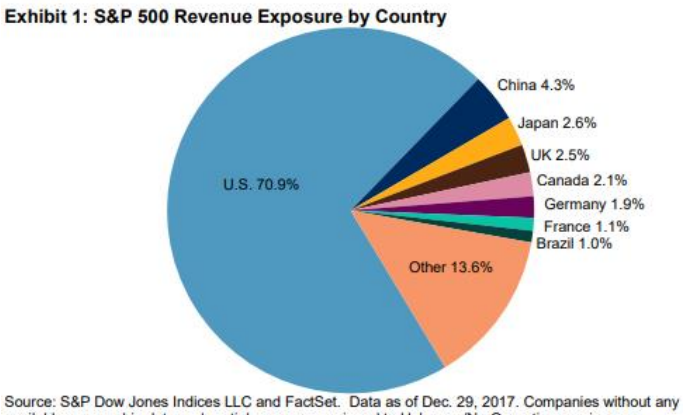
The S&P 500 is 5% from its all time highs (at the time of writing this). The Nasdaq 100 hit all time highs in June and Dow Jones, the least favourite child, is still suffering from the Trump blues, down 9% from it's all time highs seen in January. Trump's policies have a greater impact on the Dow Jones constituents. We do see the merits in open markets with few or no tariffs, but ultimately China and Europe conceding to the US's demands. For example, the US suffers in the Pharmaceuticals industry where it funds most drug development. Some may argue the US, with the present state



of it's healthcare system, is at fault, however, we are certain that if other nations had the same structure they would be rather more vehement about the burden on its citizens.

The coming 12 months will be of interest as Central Banks diverge in their monetary policies. Net money supply is shrinking as the Fed and ECB make for hawkish overtures (see chart above). On the flip side we see the Chinese government become more dovish as a function of higher rates in the West. It might just turn out to be ugly in the end for the Orient.

The next few years will be interesting as a confluence of macro factors play out; from higher rates, a stronger dollar



Source: S&P Dow Jones Indices LLC and FactSet. Data as of Dec. 29, 2017. Companies without any available geographic data and partial revenues assigned to Unknown/No Operations regions are excluded from the chart. Chart is provided for illustrative purposes.

^Calculations are based on total returns and net of all fees but before tax or the buy/sell spread. Performance figures are based in AUD. **Past performance is not a reliable indicator of future performance**.

and lower monetary liquidity. How Asia handles the fallout of a credit binge will keenly be monitored. We are pretty certain that we could see greater volatility and regional shocks.

However, fundamentally the US consumer and economy should fair relatively well from any fallout. The US stock market could experience heightened but contained volatility with 30% of S&P 500 revenues sourced outside USA, mostly from the EU.

In the end, we feel the US is in a stronger position than other nations as US corporates are in a much stronger financial position than in previous years. Where balance sheets were over stretched and capital discipline was in question, we are now in less fragile times. We fervently feel the current secular shifts are unlikely to end anytime soon. However, we do not discount a major pull back in asset prices in the order of 20% plus given the bifurcation in the markets. Here a small number of stocks represent a large percentage of indices and hence performance. ETF's and other products will panic and sell indiscriminately, which ultimately benefits managers like Wenlock Capital from price disparities. It doesn't take much to see markets fall significantly given the quantum of the super large cap stocks.

According to Thomson Reuters, over 80% of the S&P 500 returns year to date have been generated by 5 stocks, most of which include Microsoft and the FAANG stocks but excluding Google/Alphabet. We will remain protected.

Portfolio Review

There was only one purchase over the period, namely Intel. There were no sales during the period.

The top 5 contributors to performance were Twitter, Amazon, Apple, Visa and Square. The bottom 5 were Cloudera, Kion, PagSeguro, Cognex and Celgene.

Intel

Our rationale for the investment in Intel is a function of our investment process, as is the case with all the fund's holdings. Intel generates a mixed reaction, but mostly negative and it feels like a contrarian play. Intel meets all our checks when it comes to our investment process.

✓ Operating and Free Cash Growth – +10% growth

✓ CFROI/ROIC double digit and growing > 15%

✓ Attractive Free Cash Flow yield - > 6%

✓ Disciplined Capital Allocation Policy - Progressive

✓ Long term secular tailwinds - Data Centre, IOT and AI

The biggest risk in our mind, is whether Intel is a value trap. We don't think so. It is the qualitative analysis that we feel investors are ignoring. There are concerns that Intel is 'old tech' and is losing share to the likes of AMD and NVIDIA. Although there might be some credence to claim, we feel investors are missing an important fact, that it's actual addressable market has expanded significantly to $260bn from $75bn historically. With the advent of cloud based architecture, internet of things and autonomous vehicles, not to mention next generation memory, Intel now has products in all these markets.

Similarities to Microsoft

We increasing feel that Intel's perception is much akin to that of Microsoft during the 2000's up until 2014 when Satya Nadella joined as CEO. Microsoft was deemed 'old tech' due to its PC centric model, but all that changed when Satya was appointed as CEO of Microsoft. This in truth was a pivotal point in Microsoft's recent history. A leopard can indeed change it spots. Soon after Satya's appointment the strategy changed to that of a Mobile and Cloud First model and after that, as they say, was history. Its perception changed and the market soon realised the potential of Microsoft. Intel to some extent faces the same outlook today. It is also labelled a PC centric business and not well understood but even if it is there is little or no goodwill afforded to the company. Admittedly, like Microsoft, it too has a large legacy business that is related to PCs (which have been in decline for a while). However, today that represents 50% of total sales down from 66% 5 years ago. We estimate it to reduce to 40% of sales in 5 years time. It is unlikely to fall to zero unless Intel exits the PC business, which currently we do not envisage. Like Microsoft it can't escape the gravity in a world with over 120m PCs sold per year and over 2bn installed base. The remaining 50%-60% of the business is represented by data processing products in the form of the Cloud, Internet of things, Autonomous vehicles and the next generation of memory for datacentres.

To add to Intel's conundrum, its CEO was fired after contravening company rules on relationships with subordinates. Could this be the Steve Ballmer (CEO of Microsoft before Satya) moment for Intel? Probably not, but we know the Intel board realise the importance of hiring CEO that thinks about T+2,3,4,5 etc, that is to say, he has to be a revolutionary visionary. A few of these types have been identified in reports and we anticipate a hire that will bring Intel into the new age.

We feel there is limited downside and plenty of upside if the company can continue to grow in the key areas they have identified. Although we do not focus too much on P/E's (our preferred choice is FCF yield or its inverse), it trades at 11.9x for 2018 and 11.6x in 2019. A substantial

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discount to the market and hence our asymmetric view on the company.

Protection

During the period we employed protection for 72% of the Fund's NAV. We anticipate this level to remain steady in the coming period and will look to increase protection if markets continue to rally higher.

Outlook

S&P 500 earnings forecast for 2018 have been robust with over 20% EPS growth in Q1 and Q2. The expectations remain for a similar growth trajectory for the next two quarters and economic figures suggest that the US economy is strong. Corporate cash flows are as healthy as they have ever been and companies are generating record levels of cash flows. How long this remains is the tricky question. We feel sanguine that corporates will continue to grow cash flows for

at least another year, notwithstanding higher US interest rates.

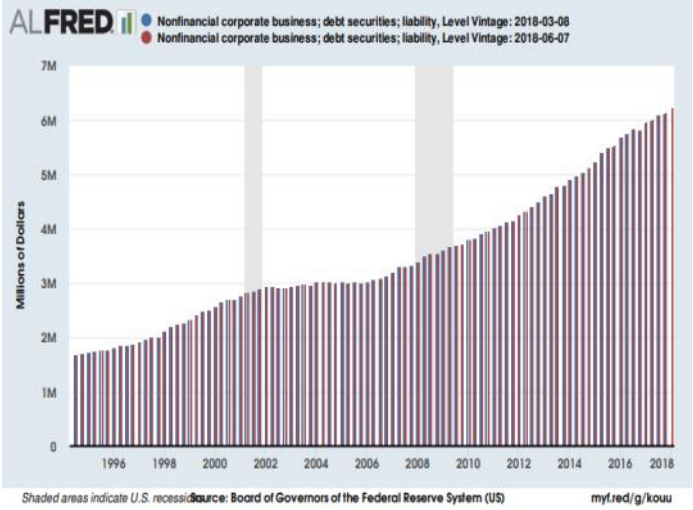
2019 EPS growth rates for the S&P 500 stand at around 10% which we feel might be vulnerable given a strong 2018.

Much ado about nothing or cognitive dissonance?

When is too much debt nothing to worry about? It would appear that the 'when' is right now. We are of course referring to the US government fiscal deficit.

Before considering government debt dynamics lets deal with how companies are fairing. We are in times when corporates are flush with copious levels of cash (see above chart) having recently paid one off higher taxes from the changes in the US tax policy. So all is fine? Well yes and no. It certainly gives us comfort that companies are generating a good level of cash and it appears this cash is growing at a good rate. Maybe the GFC, engendered fear amongst the many board members at companies or maybe post the GFC, conservatism griped our corporate leaders. Either way it is a good thing, given the previous period of profligacy. It won't be until the current crop of millennials occupy these high level positions that we see a less angst-ridden set of leaders. So companies are in safe or risk averse hands, at least for now.

Corporate debt levels have climbed to record levels in the post war time era but balanced with high levels of cash in the current cohort of market leaders, has meant net debt levels are manageable. A deeper look shows the top 10 largest global listed business (ex financials) by market value (total $6trn) will generate approx. $240bn in free cash flow next year and have on aggregate a net cash position of approx. $330bn i.e. no debt. Unfortunately, companies with large debt burdens are in the 'old economy' (Resources, Industrials etc) which we see could provide market stress if they are disrupted (think EV cars, AI etc). The top 10 largest holders of debt are amongst the Telco, Industrial, Oil and Consumer Staples sectors, with a total of $740bn of net debt and $136bn of free cash flow. At a macro level it would appear the balance sheets of corporates look extremely healthy and a crisis may not manifest from a



financial unwind, as many have pontificated. That's where the pleasant story ends, possibly.

The not so pleasant story comes in the form of the US governments generosity or largess. Admittedly, both the Trump and Obama administrations have been guilty of burdening the country with high debt levels. Under the Congressional Budget Offices (CBO) projections, the US government will add $12trn to fund the government for the next 10 years. This is based on US GDP growing 4.02% CARG over the same period. How likely do we think a recession will occur over this period? Pretty likely, but we reserve the 'you never know' quip, just look at Australia's track record. Investing is more about probables than certainties and balancing risk with capital protection is critical.

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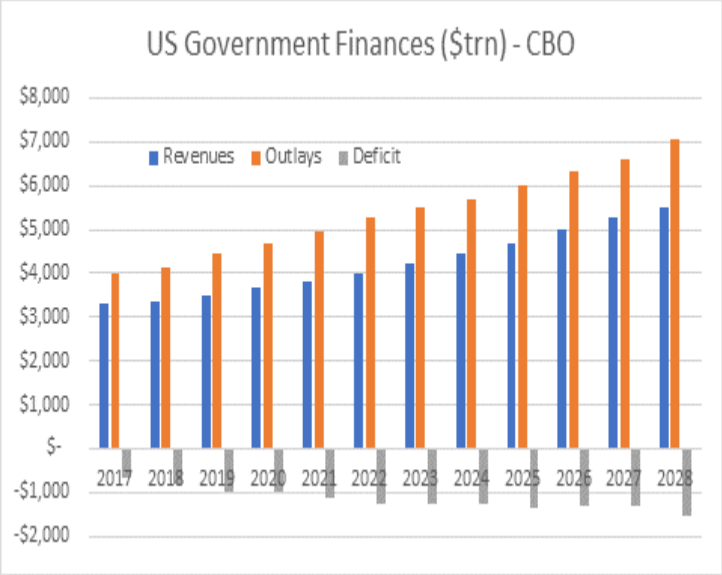
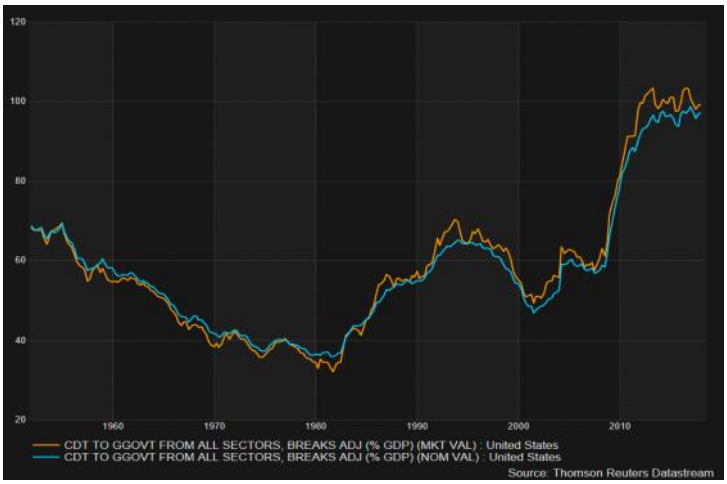
The fragility of this (CBO) construct is demonstrated in its assumptions. For example, the interest rate applied on debt is forecast to peak at 3.5% by 2022 from a current rate of 2.3%. This assumes rates won't budge up much more than the current rates, c.100bps higher. This overlayed with the fact that revenues for the US government are expected to grow over 5%



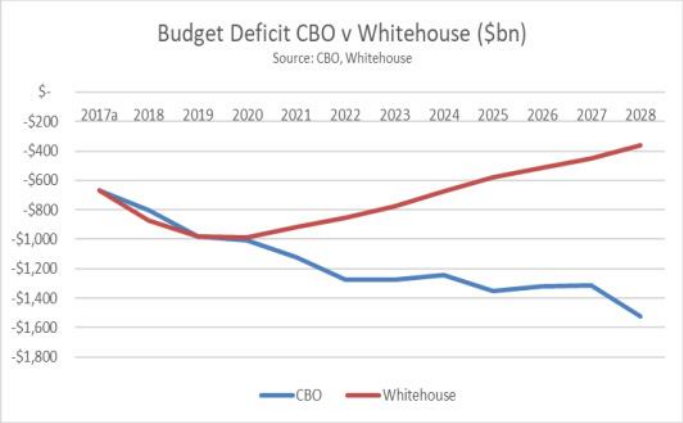
CARG for 10 years seems optimistic given the assumed growth in GDP.

The sustainability in the level of debt will come into question at some stage. Simply looking at the chart below, we are at multi decades high in Debt as a percentage to GDP, although it was marginally higher (120%) during the early 1940's due to the war efforts. At what point this is called into question by the markets will be critical, but what is certain, is that there



will be a hostile reaction in the event the market feels enough is enough. What makes the market sit up and pay attention to this is difficult to predict but as the saying goes 'what goes up must come down'. This adage might end up being a negative exponential rather than a linear trajectory in the event of an economic slowdown and thus the chart might look much uglier than expected. We all know what comes with a deteriorating debt situation, just ask half of peripheral Europe, where some states are still burdened by the pillory of indebtedness.

Comparing the US government budget to that of CBO highlights some bold assumptions that are required to balance the books. It is worth noting that CBO's baseline projections assumes caps on discretionary spend and the automatic enforcement procedures in the Budget Control Act remain in force till 2021. Hence a big divergence post



2021 in deficits (see chart below). If the administration can extend some of those policies then clearly the drain reduces, but if not then we are back to square one. Risks remain in the outer years by which time Trump might not care.

As a consequence of the 2011 US debt crisis, The Budget Control Act 2011 was put in place to ensure debt didn't balloon out of control. We knew what happened last time that occurred and Congress baulked at the idea of increasing the debt limit. The S&P 500 fell 16% in short shrift (16 days).

What we do know is a rehash of the same or very similar bad news or events have a less violent impact on the markets. So we can never be sure of what, when, or how might lead to a market correction, but we should try to educate ourselves of the potential forces that might be precursors to such events.

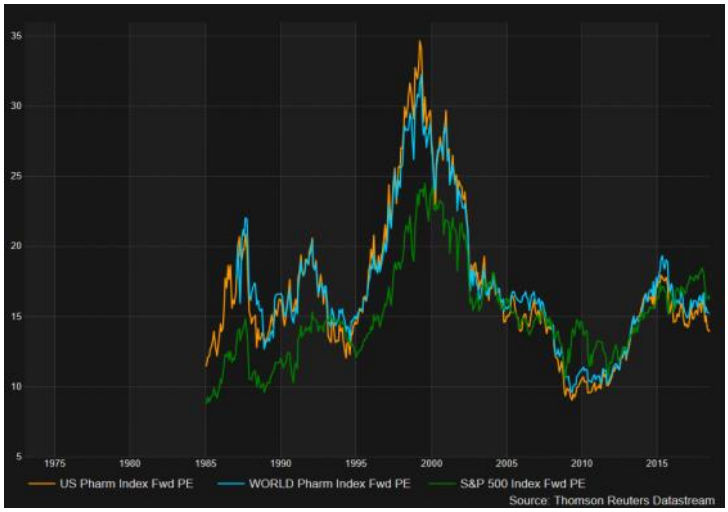
Quantifying and timing risks is an extremely difficult and fruitless task. Many famous investors have tried to predict when the ferryman of Hades (Charon) might moor, with little success. That's why we, as investors, look to insure against calamitous events for two reasons.

1. The obvious, to protect capital and
2. Equally important, to avoid investor psychological impairment i.e. irrationality and/or misplaced risk aversion. We define this as a permanent aversion to risk, where deep scars have been ingrained after major loss-

events. Where investors normal risk appetite is displaced for one that precludes from taking well balanced risk decisions. For these reasons and the fact one cannot predict when such major loss-events occur, we attempt to mitigate against such psychology. This seems reasonable and sensible to us, hence our protection strategy.

Portfolio Theme - Healthcare

We have been enthused by the Healthcare sector for a while but have been waiting for the right environment to begin increasing and concentrating our exposures. Healthcare has had a difficult few years due to a variety of factors from



political pressures over price to pipeline issues. This has led to valuation multiples contracting to levels not seen in a few years. Relative to the general market it's discount presents opportunity for a variety of reasons not least due to the defensive nature and the number of innovative drugs that are due to be released in the near future. The attractive free cash flows the sector throws off, the pipeline of new drugs, the scientific breakthroughs, a relatively benign regulatory environment are just to name a few reasons we have taken a concerted interest. On the downside, we continue to expect pricing pressures to remain an issue and we believe it has become structural in nature for the industry as a whole. However, there are pockets within Healthcare where pricing is less of an issue and payors (Medical Healthcare Insurers, Government Healthcare depts or Charities) are willing to afford their patients the drugs they require. One such area is in the Rare Disease (RD) or Orphan Drug (OD) subsegment.

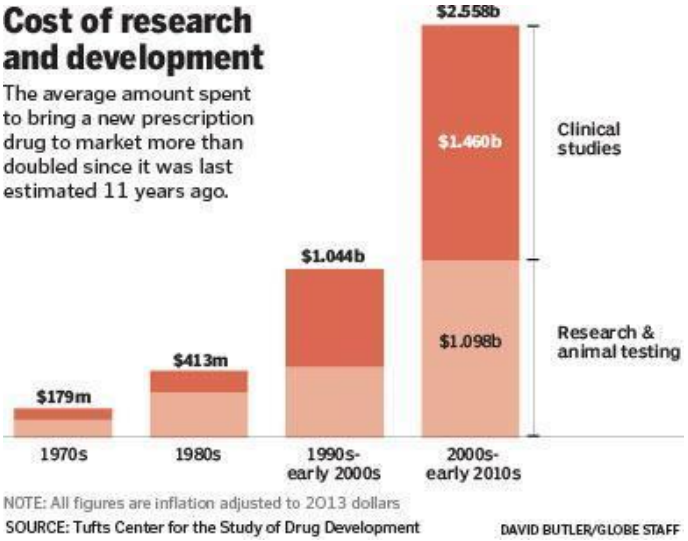
Rare Diseases

Each geography has its own definition but suffice to say, it is a disease that affects a small population where there are very few or no options for those that are affected by the underlying disease. In the US, where the disease affects less than 200,00 it is designated a RD. In the EU, a RD affects 1 in 2,000. There are over 6,000 known RDs, where 20% are a result of an environmental or similar effect and 80% are evinced from genetic backgrounds. The harrowing aspect of RDs comes from the fact that 50% of RD's affect children. RDs include:

Cystic Fibrosis - Guillian Barre
Haemophilia - Huntington

Legislation was adopted (Orphan Drug Act 1983) in the US to encourage research agencies and drug development companies to foster their efforts into addressing this area with financial incentives. In effect, it provided for better economics for drug companies to focus their efforts into addressing the needs of a relatively small population.

To put things into context, the cost of developing a drug to market is large. In fact, according to the Tuffs Centre for the Study of Drug Development its around $2.6bn and over 90% of drugs in early trials never make to the market. So one can see why drug companies want to ensure that the economics are attractive. It isn't only the financial incentives that drive the pursuit of Orphan drugs, it is innovation and time. As time passes scientist build upon previous peers efforts and along with the advent of technology we get ever closer to producing drugs that can start to address some of the RD's. In fact, up until recently diagnosis had been the tricky aspect in addressing many RD's. Since the institution of RD legislation the approval of drugs has dramatically improved. Before the Orphan Drug Act was instigated less than 10 RD drugs were approved. Since then over 400



have been approved, so still some way to go.

Due to the nature of investment in trying to innovate drugs that address RDs the payor community has been willing to fund the cost of the final drugs to patients. Recent drug pricing headlines have attracted negative sentiment in an already heavily criticised sector, so when an orphan drug is released to the market with its heavy sticker price many feel further resentment towards drug companies. However, even before the drug has hit the market drug companies engage with the payors to strike a

balance pertaining to the price of the drug. Admittedly, in the US the same drug costs will more than in other geographies such as the EU. Legislation and the structure of the US markets allows for this pricing disparity. If it wasn't for this asymmetry, it would be highly unlikely many of todays drugs would have been invented. Clearly the US is keen on addressing this imbalance. However, amongst the fracas, the RD innovators continue to price their drugs at what would appear to be exorbitant prices and payors have been accepting of their rates.

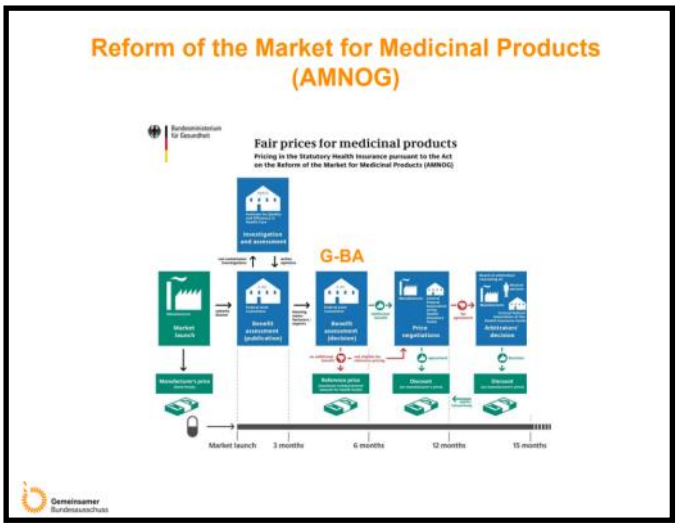
The reason? It's complicated by region.

In the US, insurance companies and the government payors fund prescription drugs. The US government does not negotiate drugs approved by the FDA. Producers determine the market price. Commercial payors will negotiate process and might want to attract more insured lives onto their platforms and list these drugs. The US has middle men who try to negotiate the prices lower they are known as Pharmacy benefit managers. They help health insurance companies and other payors reduce the cost of drugs through economies of scale. Typically the list price of RDs creates shock and awe but is significantly reduced by the time it is dispensed, known as the net price. We are seeing a rise in MEA (managed entry agreements) which involve payments based risk sharing or performance based outcomes for patients. In effect, the drug companies get paid if the drugs can show efficacy to the end

patients. More recently this has been prevalent in oncology (cancer) treatments.

These types of risk sharing will probably be the model for those drugs that have high prices. This pricing model will sharpen the focus for drug manufacturers to ensure the drugs they bring to market have the most effective outcomes to patients whilst improving their lives.

In the EU, pricing is set by each member state and they have their own methodology on whether a drug is approved. Take the UK for example, they place a monetary value on the cost of a life per year called QALY (quality adjusted life year), this is currently set at a maximum of £30,000 for standard drugs and £300,00 for rare diseases. In Germany, drugs do not go through the same funding evaluation as the UK. Drugs once approved are made available to the public at a negotiated price, funded by the state or otherwise. The health authorities will then assess the effectiveness of the drug and later decide whether it provides the benefits to patients and thus apply greater



discounts for greater volume.

The upshot

RD drugs have a major role to play in helping a small group of patients ailing from debilitating conditions with a relatively small total cost. This and the opportunity to change the outlook for many untreatable disease makes investment in the RD space an attractive proposition. Despite the high price for unit doses making headlines, the low treatment population of RD patients will not be overly burdensome to healthcare systems.

Moving to risk sharing or performance based pricing model actually creates better outcomes for patients and payors. Only the best performing drugs will be reimbursed. This will undoubtedly lead to more efficacious treatments being researched and eventually brought to market.

Drug producers that focus on RD tend have a narrow lens, whereby they direct a great deal of resources in providing treatments that most of the market ignores due to the small patient populations. As mentioned earlier the average cost to bring a drug to the market is c$2.6bn. That level of investment will require a sufficient rate of return and thus the price for RD drugs tend to be high but still lower than the current regimens. In fact, recently

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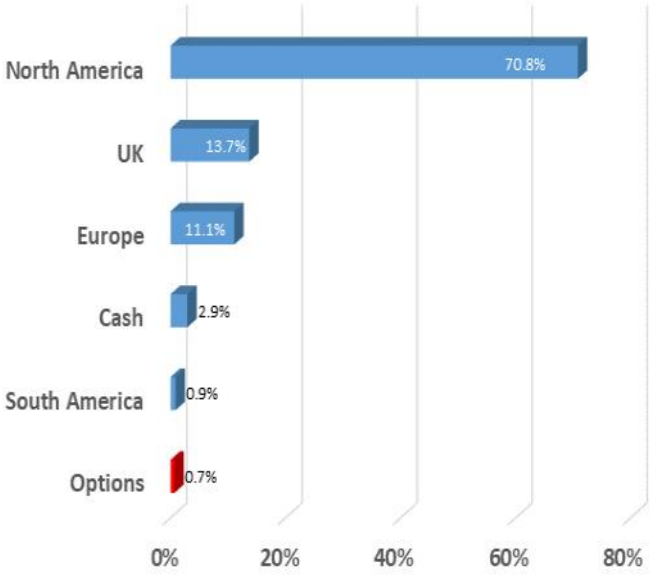
in the case of Epclusa, which cures most cases of Hepatitis C, the price of treatment collapsed as the drug showed better outcomes to a wider population. The first treatment for Hep C, Sovaldi initial cost over $80,000 in 2014 for a 12 week dose. The follow-up drug to Sovaldi, Epclusa costs well below the previous list price of $20,000. In Australia, the government has committed $1bn to help the c230,000 patients with Hep C, that works out to $4,376 per patient for a cure.

Ionis Pharmaceuticals, which we have mentioned previously provides the Fund with exposure to the RD segment. It has developed a platform, called Antisense Technology that inhibits the production of proteins at the genetic level (RNA) which causes of many rare diseases. It's lead product, Spinraza, the first ever treatment for Spinal Muscular Atrophy (SMA), the number one genetic cause of infant deaths. Without going into great detail, Spinraza corrects the genetic defect in the SMN2 gene in patients with SMA. The drug has a list price for the first treatment of $750,000 and $375,00 per patient per year thereafter. Even though the list price is extremely high the actually price paid by payors is considerably less. We estimate $300,000 per year in maintenance phase.

Ionis has a number of drugs in its pipeline of over 25 clinical trails ongoing most of which are mid to late stage. This pipeline address some important rare diseases ranging from Huntington's, Alzheimer's, hATTR, Cancers and others disease types. We accept that drug development companies like Ionis are volatile in nature due to new drug data releases. However, over the long term the opportunity for Ionis in developing drugs that have little of no treatments is one we feel has the potential to deliver long term shareholder returns.

Top 10 Holdings	Sector
Accenture	Technology
Amazon	Consumer Discretionary
Apple	Technology
Estee Lauder	Consumer Staples
Intel	Technology
Microsoft	Technology
Novo Nordisk	Healthcare
PayPal	Technology
Twitter	Technology
Visa	Technology

Country Allocation % of NAV



Fund Statistics - June 2018

Sector Allocation (ex cash)	% of NAV
Technology	44%
Healthcare	19%
Consumer Discretionary	14%
Industrials	9%
Consumer Staples	8%
Financials	2%

Currency Exposure	% of NAV
US Dollar	73%
UK Pound	14%
Euro	4%
Danish Krone	4%
Swiss Franc	3%
Australian Dollar	2%

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Performance	Fund	Index*	Relative
1 Month	+3.22%	+2.36%	+0.86%
3 Month	+7.63%	+5.68%	+1.94%
2018 YTD	+13.21%	+6.32%	+6.89%
Since Inception**	+19.64%	+15.45%	+4.19%

*MSCI Daily World Total Return Net Index AUD **Inception 9 Aug 2017

Wenlock Global Fund

- The Wenlock Global Fund targets long term capital growth whilst ensuring capital preservation . The Fund invests in 20-40 superlative businesses across the world that are exhibiting strong long term secular trends. At times, the fund employs protection to protect against large falls in asset prices.
- These superlative businesses are selected after rigorous fundamental bottom up research which provides the Fund potential long term capital returns

Investment Style	|	Bottom– up Fundamental Research based on Cash Flow Returns
Number of Holdings	|	20-40
Inception Date	|	9 August 2017
Currency	|	AUD
Minimum Investment	|	$10,000