

## K2 Asset Management

Level 32, 101 Collins Street Melbourne Victoria 3000 Australia  
Telephone 61 3 9691 6111 Facsimile 61 3 9691 6170  
Website k2am.com



# K2 Australian Fund Monthly Report - 31 August 2016

## Australian Market Review

The K2 Australian Absolute Return Fund returned 1.29% for the month of August while the S&P/ASX All Ordinaries Accumulation Index returned -1.33%.

Focus moved from macro to micro in August as reporting season hit full swing in Australia. Results were soft but not as bad as feared, as many companies called out election related weakness throughout June and July. Macro developments took a back seat, however some recent news flow must be closely monitored going forward. Chinese data showed signs of a slowdown post 1H16 stimulus, while the RMB continued to weaken against major trading partners. Rhetoric from multiple Fed officials also turned incrementally hawkish ahead of September's FOMC meeting which may heighten short-term volatility. The RBA cut rates by 25 bps to 1.50% and the AUD ended the month 1.0% lower at USD0.752.

Strong results from CPU and IRE saw Tech (+4.5%) as the best performing sector, while Energy (+2.3%) continued to grind higher despite a volatile oil price. The Telco (-8.9%) space struggled as highly regarded VOC (-13.9%) founder James Spenceley sold 76% of his shareholding in the company.

## Portfolio Insight: Macquarie Group

Macquarie Group has been a top 5 position for the fund since January 2015. Over that time Macquarie's share price has returned 51% whereas the All Ordinaries Accumulation Index has delivered just 10%. Despite this significant outperformance, we believe that Macquarie can continue to deliver superior returns.

Macquarie is currently trading on 13.3x next year's earnings and offers a 5% dividend yield. We are of the view that these valuation multiples are still attractive given Macquarie's expertise in infrastructure asset management and advisory services. It is clear that globally there is an emerging trend towards fiscal stimulus and infrastructure spending. Macquarie is widely seen as the most logical beneficiary of this expenditure and should be able to generate an attractive stream of future profits from its \$200 billion asset base in a capital light manner.

## Outlook

The median PE for Australia's leading companies is now 17x next year's earnings. Historically this valuation multiple has been difficult to trade through. However, the current low inflationary backdrop adds valuation support to all long duration assets and equities are no exception. So looking forward we need to consider where we are in the profit cycle and whether inflation has been sustainably contained.

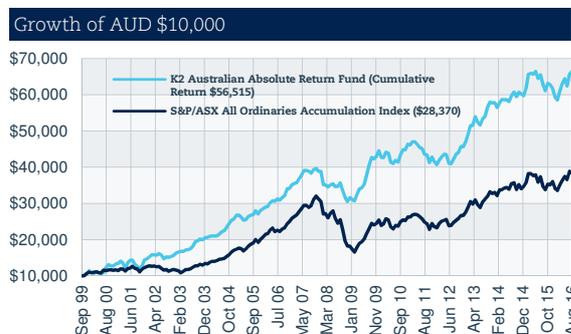
The second half FY16 profit reporting season is now complete and the results were pedestrian. Corporates on average gave little in the way of forward guidance so EPS estimates for 2017 were largely unchanged. We believe that trading conditions are gradually improving in Australia and as a result profit growth should follow. If profit growth improves, then relatively high valuation multiples can hold for a while longer. However, this would also require a benign inflation back drop.

Importantly, Australia's historic inflation premium is unwinding. For the last 35 years Australia's average inflation rate has been 1.4% higher than that of the OECD G7. As of June 2016, Australia's inflation premium had declined to just 0.4%. Hence we feel that any upward inflation risks will emanate from global forces and the most likely sources will be commodity and labour related. Currently there are no major disruptions so we are relatively comfortable that near term inflation pressures are minimal. That said, we are watchful for any signs of supply constraints particularly post the Brexit decision.

## Top 5 Stock Contributions - August

<b>Largest</b>	BHP Billiton Limited, Fletcher Building Ltd, JB Hi-Fi Ltd, Macquarie Group Ltd, Retail Food Group Ltd
<b>Smallest</b>	Gateway Lifestyle, Japara Healthcare Ltd, Medical Developments International, RIO Tinto Ltd, Vocus Communications Ltd

Performance to 31 August 2016 (net of fees)	
1 Month	1.29%
3 Months	3.22%
6 Months	13.57%
1 Year	5.87%
3 Years (pa)	7.16%
5 Years (pa)	8.94%
10 Years (pa)	7.71%
Since Inception (pa)	11.85%



Returns are based on NAV per unit plus distributions reinvested net of management fee and performance fee accruals. The method for calculating the NAV is set out in the Fund's PDS.

Fund Details (Unaudited)	
Exit Price Per Unit:	A\$179.25
Distribution 30-Jun-2016:	A\$3.89
Fund Size:	A\$386.3m
Start Date:	01-Oct-99

Top 5 Large Cap Holdings	Sector	%
BHP Billiton Limited	Basic Materials	9.2
RIO Tinto Ltd	Basic Materials	7.2
Vocus Communications Ltd	Communication	5.5
Macquarie Group Ltd	Financial	5.4
South32 Ltd	Basic Materials	3.8

Sector Exposure %			
	Long	Short	Net Equity
Basic Materials	21.6	-	21.6
Communication	12.7	-	12.7
Cons. Cyclical	12.3	-	12.3
Cons. Non-Cyc	12.3	-	12.3
Energy	0.7	-	0.7
Financial	29.1	-0.5	28.6
Industrial	4.5	-	4.5
Technology	1.0	-	1.0
Utilities	0.2	-	0.2
<b>Total Equity</b>	<b>94.4</b>	<b>-0.5</b>	<b>93.9</b>
<b>Total Cash</b>			<b>6.1</b>
<b>Total Equity and Cash Exposure</b>			<b>100.0</b>

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