

K2 Asset Management

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K2 Australian Fund Monthly Report - 31 July 2016

Australian Market Review

The K2 Australian Absolute Return Fund returned 5.14% for the month of July while the S&P/ASX All Ordinaries Accumulation Index returned 6.29%.

Global equity markets performed well during the month; the average equity market gain within Asia, Europe and the America's region was 3.4%, 3.5% and 5.4% respectively. Investors generally embraced the view that, in the wake of the "Brexit" victory, interest rates would probably stay lower for longer. The Federal Reserve kept rates on hold during the month and bond yields around the world declined for the third consecutive month. The oil price weakened 14% and volatility measures generally moved lower. Bucking the trend, the price of spot iron-ore rose 6.7% and nickel jumped 12.6%. The Australian dollar tended to follow metal prices rising 1.9% for the month and closed at USD0.7596.

Consumer Discretionary (+8.8%) and Staples (+8.5%) were the best performing sectors for the month. Materials (+7.8%), Healthcare (+6.8%) and Utilities (+6.6%) were also strong. Energy (+0.2%) was the worst performer.

Portfolio Insight

For the first time in over three years, our exposure to Basic Material companies is 20%. We began buying in February this year when BHP and RIO abandoned their progressive dividend policies. Our increased exposure also coincided with a 20% decline in metal prices in just 6 months. We have skewed the Basic Material exposure to BHP, RIO and South32 as we believe that the major players will have the greatest capacity to deliver improved returns to shareholders. We are also mindful that this exposure will give the portfolio a natural hedge if interest rates should unexpectedly move higher.

BHP is the biggest holding for the fund. We are attracted by its portfolio of tier one assets that are advantageously positioned in the lowest portion of the cost curve. We believe that BHP can generate strong free cash flow in the future. BHP's operations tend to have high EBITDA margins and coupled with a simpler operating model and a more disciplined approach to capital expenditure, we are confident that BHP can reward shareholders with more prospective returns. We are also hopeful that at some stage this cycle shareholders should benefit from BHP's excessive surplus franking credits of AUD14billion. In addition, we believe that BHP's earnings expectations have considerable upside; particularly if spot commodity prices are rolled into forward estimates. Although BHP's share price has recovered 30% from its lows earlier in the year, it is still trading 40% lower than where it was just 2 years ago.

Outlook

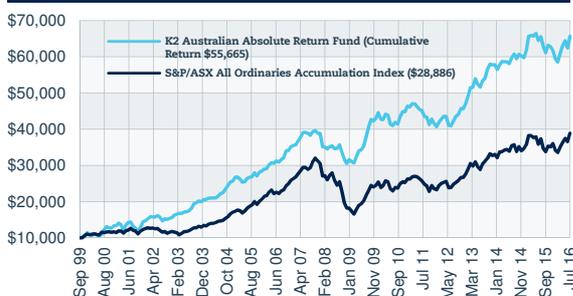
The average 10 year bond yield for the developed economies is now just 43 basis points. It would also appear that the consensus view is that this yield can fall further. As a result, investors are more willing to pay up for growth. By way of example, the median PE of the 20 largest listed companies in New Zealand and the US is now 22x and 19x respective earnings next year. In Australia, if we exclude the 4 major banks, the median top 20 company PE is now 18x earnings next year. Given that the PE of most global equity markets have re-rated by 20% in just 6 months, we need to carefully assess our valuation inputs. Although near term conditions should continue to favour a low inflationary back-drop, we are watchful for data points that might indicate that an interest rate turning point is approaching. In the meantime, equities will continue to look more attractive than competing asset classes.

Top 5 Stock Contributions - July

Largest	BHP Billiton Limited, Macquarie Group Ltd, RIO Tinto Ltd, South32 Ltd, Vita Group Ltd
Smallest	Bank of Queensland Ltd, Lendlease Group, National Storage REIT, Pact Group Holdings Ltd, Syrah Resources Ltd

Performance to 31 July 2016 (net of fees)	
1 Month	5.14%
3 Months	4.19%
6 Months	10.52%
1 Year	0.19%
3 Years (pa)	7.17%
5 Years (pa)	8.54%
10 Years (pa)	7.81%
Since Inception (pa)	11.83%

Growth of AUD \$10,000



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\$176.96
Distribution 30-Jun-2016:	A\$3.89
Fund Size:	A\$385.7m
Start Date:	1-Oct-99

Top 5 Large Cap Holdings	Sector	%
BHP Billiton Limited	Basic Materials	8.5
RIO Tinto Ltd	Basic Materials	6.5
Vocus Communications Ltd	Communication	5.4
Macquarie Group Ltd	Financial	5.0
South32 Ltd	Basic Materials	3.5

Sector Exposure %

	Long	Short	Net Equity
Basic Materials	19.7	-	19.7
Communication	10.9	-	10.9
Cons. Cyclical	10.9	-	10.9
Cons. Non-Cyc	10.2	-0.3	9.9
Energy	0.5	-	0.5
Financial	31.7	-1.2	30.5
Industrial	5.6	-	5.6
Technology	1.0	-	1.0
Utilities	0.2	-	0.2
Total Equity	90.7	-1.5	89.2
Total Cash			10.8
Total Equity and Cash Exposure			100.0

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