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K2 Australian Fund
Monthly Report - 31 October 2016

Australian Market Review

The K2 Australian Absolute Return Fund returned -1.40% for the month of October while the S&P/ASX All Ordinaries Accumulation Index returned -2.18%.

The US election dominated news flow as rounds two and three of the presidential debate series took place, while the FBI re-opened the Clinton email scandal on month end. A skittish start to November trading is likely to follow as polling day approaches. While entertaining, it remains a concern that these two candidates are fighting it out to govern the world's largest economy. Bond markets continued to sell-off globally as investors kept one eye on the prospects of a December US rate rise. While the macro backdrop proved difficult for the interest-rate sensitive Aussie market, resources again surprised on the upside. Company specific news was generally refined to US reporting season, but the tragic death of four at Dreamworld crushed Ardent Leisure Group (-23%) and called theme park safety into question. The RBA left rates on hold at 1.50%, while the AUD fell 0.7% to USD0.7608.

The under owned Materials sector (+1.3%) was again the best performer as iron ore (+15.3%) continued an unlikely rally. A big downgrade from Healthscope ensured a messy month in Healthcare (-8.3%), while REITs (-7.9%) remained under pressure as the bond sell-off market drove discount rates higher.

Portfolio Insight: Australian REITs

During the month the Australian 10 year bond yield rose by nearly 50 basis points; the largest rise since May 2009. The move in the Australian 10 year bond yield was more violent than that of the average G7 country move which was up 28 basis points. Accordingly Australian long duration assets tended to underperform global peers. By way of example, the Australian REIT (A-REIT) index fell 7.9% for the month whereas the global REIT index dropped 5.5%. We are marginally net short the A-REIT index. One of our concerns stems from the fact that the three largest index funds in Australia now own about 20% of every listed A-REIT company.

The market capitalisation of the A-REIT sector has risen from $43 billion in March 2009 (4.8% of the ASX200) to $127 billion today (8.3% of the ASX200). The growth in the value of the A-REIT sector has been remarkably consistent at nearly 1% every month and has broadly mirrored the decline in interest rates. Importantly just 7 companies make up about 75% of A-REIT index. Given that index funds tend to bias their portfolios to the largest companies as opposed to the best value companies it is little wonder that index funds now dominate the A-REIT sector. However index funds under-appreciate the fact that A-REITs are now trading at a more than 20% premium to their book-values. In addition, index funds are unlikely to recognise that commercial property values have been constructed using capitalisation rates that have mirrored QE influenced long bond rates. They are also unlikely to identify the subdued levels of rental income growth. Index funds' A-REIT positions tend to reflect that fact that the size of the sector has grown 1.7 times faster than the broad market. We believe that commercial property values are stretched. We also believe that rental income growth prospects are subdued and that book value capitalisation rates can't fall much further. Index funds have been massive buyers of A-REITs for the past 5 years and will most likely become sellers over the next 5 years.

Outlook

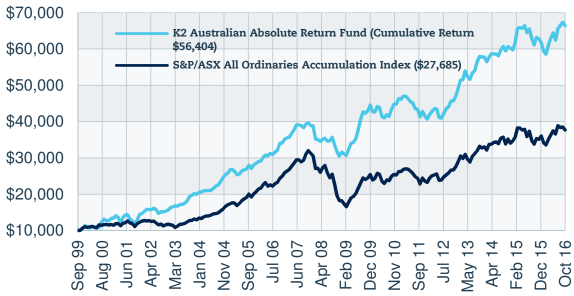
We continue to believe that Australian equities look relatively attractive. The ROE for the Australian equity market is 20% higher than developed peer nations yet balance-sheet leverage is 30% lower. Despite this, the dividend yield of the Australian equity market is amongst the highest in the world. Accordingly we continue to be comfortable running relative high net exposure. We would point out that our portfolio is significantly different to the broader market. Our weighting in Australia's 20 largest companies is half that of the broader market. In addition our average holding has a beta of 0.87 and therefore, theoretically less volatile.

Top 5 Stock Contributions - October

Largest	BHP Billiton Limited, Challenger Ltd, Corporate Travel Management,
	RIO Tinto Ltd, South32 Ltd
Smallest	AMP Ltd, Fairfax Media Ltd, News Corp, Vita Group Ltd,
	Vocus Communications Ltd

Performance to 31 October 2016 (net of fees)	
1 Month	**-1.40%**
3 Months	**1.13%**
6 Months	**5.36%**
1 Year	**5.06%**
3 Years (pa)	**4.64%**
5 Years (pa)	**9.18%**
10 Years (pa)	**6.92%**
Since Inception (pa)	**11.72%**

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$178.95**
Distribution 30-Jun-2016:	**A$3.89**
Fund Size:	**A$374.8m**
Start Date:	**01-Oct-99**

Top 5 Large Cap Holdings	Sector	%
BHP Billiton Limited	Basic Materials	**9.9**
RIO Tinto Ltd	Basic Materials	**7.8**
Macquarie Group Ltd	Financial	**5.4**
South32 Ltd	Basic Materials	**4.5**
Vocus Communications Ltd	Communication	**4.2**

Sector Exposure %	Long	Short	Net Equity
Basic Materials	22.7	-	**22.7**
Communication	10.6	-	**10.6**
Cons. Cyclical	11.3	-	**11.3**
Cons. Non-Cyc	10.8	-	**10.8**
Energy	0.7	-	**0.7**
Financial	34.9	-0.8	**34.1**
Industrial	4.2	-	**4.2**
Technology	0.8	-	**0.8**
Utilities	0.2	-	**0.2**
Total Equity	**96.2**	**-0.8**	**95.4**
Total Cash			**4.6**
Total Equity and Cash Exposure			**100.0**