

K2 Asset Management

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K2 Australian Fund Monthly Report - 30 September 2016

Australian Market Review

The K2 Australian Absolute Return Fund returned 1.25% for the month of September while the S&P/ASX All Ordinaries Accumulation Index returned 0.40%.

With reporting season complete, it was once again macro factors driving market direction. Janet Yellen held rates constant at a much anticipated Fed meeting, while continuing to flag that prospects for future increases have grown. Theatrics surrounding November's US election gathered momentum as Clinton and Trump traded blows in history's most watched Presidential debate. While neither candidate covered themselves in glory, the relief rally in the Mexican Peso suggested markets awarded Clinton a minor victory. Oil performed strongly as OPEC agreed in principle to cut output for the first time since 2008, but we await the agreement of national quotas at November's formal meeting before getting too excited. Financial stocks were volatile globally as murmurings of counterparty risk engulfed Deutsche Bank, while Chancellor Merkel ruled out state-based assistance which did little to ease fears. Domestically the Reserve Bank of Australia (RBA) held rates at 1.5% while the AUD strengthened 1.9% to USD0.766.

Materials (+4.9%) was the best performing sector as commodity prices continued their resilience. Crowded defensives were notable under performers in the midst of aggressive rotation as REITs (-4.3%), Telco's (-4.1%), and Utilities (-3.7%) weighed heavily on the market.

Portfolio Insights - Banks

Last month Philip Lowe was appointed as the new Governor of the RBA. His maiden speech was to the House of Representatives Standing Committee on Economics where he was questioned extensively about Australian banks. Lowe highlighted that, as a result of international regulatory developments, banks were required to hold more liquid assets. Liquid assets tend to have relatively low yields and therefore drag on banks' revenue. Lowe suggested that, given that Australian banks had opted to maintain their underlying return on equity (ROE), borrowers predominately subsidised profitability instead of shareholders. We do not entirely agree with this view. Shareholders have subscribed to significant equity raisings by the banks over the past 3 years. As a result, Australian bank capital ratios have subsequently risen by over 2% thus diluting ROE by a similar magnitude. This thematic has kept us underweight the major banks since mid-2013.

Encouragingly, Lowe also stated that he thought the finance sector had withstood "a period of very accelerated regulatory change" and that this should now be left to settle to see how the system adjusts. We share this view and have started adding to our major bank exposure over the past 8 weeks. It would appear to us that the EPS for Australia's major banks are nearing a cyclical trough and over the coming year should start to trend higher. Hence we are comfortable buying banks at these levels (12x next year's EPS).

Outlook

We believe that the case for investing in equities is still compelling. However, we are mindful that there are two events that are scheduled to occur before year end that could cause some equity market dislocation; the US election on the 8th of November and a potential rate rise by the US Federal Open Market Committee. For the moment we are content to hold relatively high net exposure. However, we will be closely monitoring the forthcoming US third quarter profit season and currency markets for insights into investors' temperament.

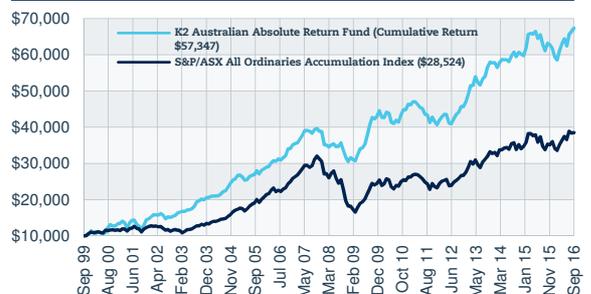
Top 5 Stock Contributions - September

Largest	Amaysim Australia Ltd, BHP Billiton Limited, Challenger Ltd, RIO Tinto Ltd, South32 Ltd
Smallest	CYBG PLC, Hughes Drilling Ltd, Suncorp Group Ltd, Tegel Group Holdings Ltd, Vocus Communications Ltd

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Performance to 30 September 2016 (net of fees)	
1 Month	1.25%
3 Months	7.83%
6 Months	10.16%
1 Year	10.20%
3 Years (pa)	6.02%
5 Years (pa)	10.28%
10 Years (pa)	7.68%
Since Inception (pa)	11.87%

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\$181.27
Distribution 30-Jun-2016:	A\$3.89
Fund Size:	A\$385.4m
Start Date:	01-Oct-99

Top 5 Large Cap Holdings	Sector	%
BHP Billiton Limited	Basic Materials	10.1
RIO Tinto Ltd	Basic Materials	7.4
Macquarie Group Ltd	Financial	5.4
South32 Ltd	Basic Materials	4.7
Vocus Communications Ltd	Communication	4.7

Sector Exposure %

	Long	Short	Net Equity
Basic Materials	23.3	-	23.3
Communication	11.5	-	11.5
Cons. Cyclical	13.5	-	13.5
Cons. Non-Cyc	11.4	-	11.4
Energy	0.7	-	0.7
Financial	31.1	-	31.1
Industrial	4.3	-	4.3
Technology	0.7	-	0.7
Utilities	0.2	-	0.2
Total Equity	96.7	-	96.7
Total Cash			3.3
Total Equity and Cash Exposure			100.0