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K2 Australian Equity Update
Quarterly Report - 30 June 2017

Market Review

The K2 Australian Absolute Return Fund returned 0.0% for the quarter ending 30 June 2017 while the S&P/ASX All Ordinaries Accumulation Index returned -1.5%.

The Australian market weakened slightly during the June quarter as the Aussie consumer hit a speedbump and global growth waned. A move by the Australian government to impose a 6bp charge on bank liabilities shook the banking sector, while further rate increases for interest-only borrowers put a squeeze on retail spending. Hysteria surrounding the impending arrival of Amazon in Australia only compounded the de-rate in discretionary retail. The resource sector traded mixed as the underlying commodities responded to a slowdown in China, with WTI (-9.0%) and Iron Ore (-19.2%) lower for the quarter. The Fed followed March's 25bps hike with another in June, while comments surrounding the balance sheet unwind began to test the waters. Mario Draghi's first hawkish comments in late June also suggest the days of easy money are coming to an end. The RBA left rates on hold at 1.5%, while the AUD was 0.8% stronger at USD0.7689.

Industrials (+7.2%) were the best performing sector over the quarter, while Healthcare (+6.5%) continued its strong outperformance after a market leading 14% gain in 1Q. Weakness was again seen in the Telco sector (-7.5%) as TPM spent $1.3 billion at the April spectrum auction, a clear indication that competition is coming fast in the mobile space. Financials (-6.5%) were also held ransom to the bank levy in the federal budget.

Outlook

The K2 Australian Fund progressively reduced net exposure during the June quarter. Long exposure was reduced from 88.7% in March 2017 to 54.5%. In addition the Fund's short exposure rose from 2.4% in March 2017 to 4.4%. Accordingly, the Fund's net exposure is 50.1%; 36.2% lower than 3 months ago. An important consideration for our reduced equity market exposure was the limited valuation upside at this point in the earnings cycle.

During the quarter the PE for the median top 100 Australian listed company was 16.9x next year's EPS. This is more than 15% higher than the average over the past 25 years. Typically, when high valuation multiples coincide with a mature earnings cycle prospective equity market returns tend to be pedestrian. We believe that Australia's ability to sustainably grow corporate earnings is becoming increasingly complicated. In addition, it is likely that discount rates for valuation purposes will gradually rise. As a result we feel that the probability of a 10% investment return is declining and that the most appropriate action is to increase cash holdings. Cash allows us to protect investors' capital whilst providing the flexibility of redeployment when prospective returns look more favourable.

The outlook for Australian corporate earnings has been impacted by the uncertain operating environment for the major banks. The recently announced major bank levy will ultimately lift borrowing costs for certain mortgage holders; namely property investors who have borrowed on interest-only terms. Rates for investor interest-only loans have already jumped 70 basis points in just 8 months and are now at the highest level since 2013. Unfortunately, property investors will need to absorb these higher funding costs; the continued surge in supply of apartments ensures that existing tenants will have greater variety of occupancy options. Hence rents are unlikely to rise any time soon. Moreover, we are mindful that recent property investors could increasingly breach dynamic LVR covenants over the coming year. If banks start taking possession of underperforming investor loans, we feel that a negative feedback loop would follow and bad debt charges will ultimately intensify. The fund has a minor 3.4% holding in the major banks.

There also appears to be more unified central banker rhetoric regarding the removal of monetary policy accommodation. Over the past 9 years the US Federal Reserve, the European Central Bank and the Bank of Japan have collectively increased the size of their balance-sheets by more than USD9.5 trillion. Unsurprisingly, the average 10 year bond yield of the US, Eurozone and Japan has fallen nearly 250 bps since 2008 and is currently just 0.95%. Interestingly the volatility of these long bonds has dramatically declined. We feel that as monetary policy accommodation tapers, long bond yields will become more volatile and higher yields will prevail. This should translate into higher valuation discount rates over the coming year. Hence we feel that the median PE for Australia's leading companies looks 15% too high.

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Portfolio Insight: Shorts - K2 Australian Fund

Given our view on the outlook for Australian equities the K2 Australian Fund has increased short exposure to the highest levels in over 5 years. Like all investments, short positions are subjected to our investment process which focusses on four key areas of the company; the **industry** in which they operate, their **earnings**, the quality of **management** and **valuation**.

We are currently short **Coca-Cola Amatil** (CCL) and **Domino's Pizza Enterprises** (DMP) on the basis that valuations underestimate their earnings risk.

Coca-Cola Amatil is the Australasian anchor bottler in the Coca-Cola system with 80% of their sales volume derived from carbonated soft drinks (CSDs) and water. The structural decline in both volumes and prices across the CSD market has been driven by increased consumer awareness around the negative effects of sugar consumption. This structural decline is accelerating and given the global adoption of sugar taxes, there is heightened risk Australian policy makers may follow suit.

Management has been successful in offsetting the earnings impact by a series of cost out programs, however with accelerating negative CSD trends and cost cutting becoming incrementally more difficult, earnings risk is skewed to the downside. Despite this deteriorating earnings outlook, the company is trading at a premium to historical averages that we expect will de-rate over the medium term as earnings disappoint.

Domino's Pizza Enterprises is Australia's largest takeaway pizza chain that has delivered astronomical gains for shareholders over the long term. The company has enjoyed an earnings upgrade cycle via the successful rollout of franchise stores across Australia & New Zealand, combined with entering into new markets in Europe and Asia. This sustained earnings growth has been rewarded by the market with a substantial PE re-rating, currently 38x 2017E earnings. Key to the success of the Domino's model is the ability to roll out new franchises and drive sales growth across the network. While successful to date, we are of the view that it will be difficult to maintain this rate of growth going forward. Despite strong sales growth, franchisee profitability has remained flat. With rising costs of doing business, increased competition via menu aggregators, and an ongoing investigation into the underpayment of staff at the franchisee level, there will be growing pressure for Domino's to cede some profits back to the franchisees. We would expect that given the growth expectations embedded within Domino's multiple, future earnings disappointments will be met with a corresponding de-rating.

Portfolio Insight: Citadel Group - K2 Australian Small Cap Fund

Citadel Group is a technology company specialising in the secure handling of information and communications in complex environments. Successful service delivery over the past 15 years has resulted in a sticky blue-chip client base within government departments, healthcare, education, and the defence force.

A spate of global ransomware attacks over the past 6 months, most notably WannaCry, underscores the importance of data security in every aspect of modern business. This thematic underpins our confidence that strong demand for these services will exist irrespective of growth in the broader economy.

The importance of Citadel's offering is best explained via examples of existing contracts either in pilot mode or under their control. The Department of Defence contract controls the electronic document and records management environment within the Australian DoD, ensuring the security of over 500m documents across 110,000 users. The Secured Content and Collaboration Service pilot is a new initiative placing sensors and other receivers on Australian fighter jets, ships, submarines etc to convey timely information to a centralized base from low/no-bandwidth environments. Through the Monash University partnership, Citadel has also developed the world's largest multi-point video conferencing deployment where the entire student-teacher-staff population of 25,000 people can connect real-time from anywhere using any device. With health also a key vertical, Citadel's Laboratory Information Management System AUSLAB controls the pathology information of over 30% of Australians who receive treatment in a public hospital. This includes the online storage and retrieval of documents for clinical viewing.

Trading on 14x FY18 PE, with a history of double digit organic growth and an extremely invested management team, Citadel remains a core holding in the K2 Australian Small Cap Fund. While organic growth looks underpinned by a favourable macro thematic, the net cash position also lends itself to further growth via deployment into accretive acquisitions.