

K2 Asset Management

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K2 Australian Fund Monthly Report - 31 December 2016

Australian Market Review

The K2 Australian Absolute Return Fund returned 2.94% for the month of December, while the S&P/ASX All Ordinaries Accumulation Index returned 4.17%.

Global markets traded strongly in December as the customary 'Santa Rally' took hold. A weaker than expected MYEFO update from the government halted the domestic bond sell-off, with yield sensitives finally joining the cyclical rally as a result. Oil continued its surge post OPEC with WTI +8.7%, helped further by a Russian commitment to join the production cuts. Chinese markets were a notable underperformer as the Renminbi continued to slide towards the psychological level of 7.00. Rhetoric around Trump's protectionist policies continued, while the appointment of 'Death by China' author Peter Navarro as his trade adviser did little to ease trade tensions. The RBA left rates on hold at 1.50%, while the AUD fell 2.5% to USD0.7208.

The lagging yield sensitive sectors were the winners in December as Utilities (+7.4%) surged. Energy (+6.1%) also performed well post OPEC. Telco's (+0.4%) struggled again as investors continued to assess the long-term NBN implications. Materials (39.1%) were the best performing sector throughout calendar year 2016, while Telco's (-12%) again brought up the rear.

Portfolio Insight: Market Exposure

Since the fourth quarter of 2012 we have consistently found compelling equity market investment opportunities. Four years ago, we were convinced that Australia's major inflationary headwinds of excessive mining related capital expenditure and the carbon price had passed and that economic activity would subsequently become more predictable. We were also buoyed by the fact that the Australian 10 year bond yield was just under 3% whereas the PE ratio of the equity market was about 14x next years' earnings. We believed that the valuation gap would close and accordingly our net exposure has average 87% for more than 4 years; 20% higher than our average exposure during the prior 13 years. Interestingly, today the Australian 10 year bond yield is still just under 3% whereas the PE of the equity market is over 16.5x next years' earnings.

One of the consequences of us being structurally bullish equities is that shorting becomes an opportunity cost; we do not gear the fund hence our gross exposure is capped at 100%. Accordingly, our short exposure since September 2012 has averaged just 0.25%; 7% lower than our average exposure during the prior 13 years. Given that the PE of the Australian equity market has appreciated nearly 20% we feel that the valuation arbitrage has largely played out. Hence, we would anticipate that should the 10 year bond yield move beyond 3%, opportunities to short sell will increasingly be rewarded. This would most likely correspond to us running lower net exposure to ensure that recent performance gains are preserved.

Outlook

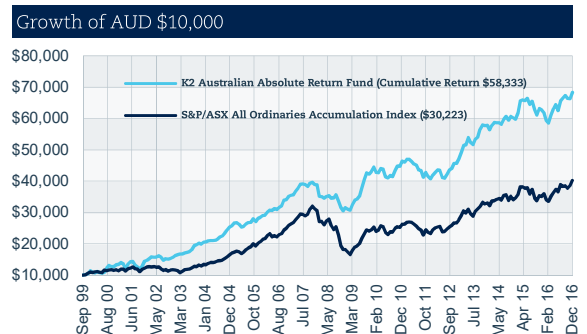
On 20 January, Donald Trump will become the 45th president of the United States. Broadly, asset markets have embraced his pro-growth ideals and business savvy administration. However, it is too early to determine the likely inflationary and geopolitical implications of future policy actions. We note that US consumer confidence has already moved sharply higher and this typically coincides with improved labour market conditions. If the US labour market continues to tighten, the US dollar keeps strengthening and commodity prices remain firm, then it would seem inevitable that bond yields move higher. Equity market valuation multiples are unlikely to expand further however share prices can still advance if earnings grow at a faster rate than the economy.

Top 5 Stock Contributions - December

Largest	BHP Billiton Limited, National Australia Bank Ltd, RIO Tinto Ltd, Retail Food Group Ltd, Suncorp Group Ltd
Smallest	Citadel Group Ltd/The, Dexus Property Group, Gateway Lifestyle, Ingenia Communities Group, Netcomm Wireless Ltd

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Performance to 31 December 2016 (net of fees)	
1 Month	2.94%
3 Months	1.47%
6 Months	9.41%
1 Year	10.66%
3 Years (pa)	5.73%
5 Years (pa)	10.92%
10 Years (pa)	6.87%
Since Inception (pa)	11.79%



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\$184.15
Distribution 30-Jun-2016:	A\$3.89
Fund Size:	A\$366.7m
Start Date:	1-Oct-99

Top 5 Large Cap Holdings	Sector	%
BHP Billiton Limited	Basic Materials	9.9
RIO Tinto Ltd	Basic Materials	7.1
Macquarie Group Ltd	Financial	6.1
South32 Ltd	Basic Materials	4.4
National Australia Bank Ltd	Financial	4.2

Sector Exposure %			
	Long	Short	Net Equity
Basic Materials	21.9	-	21.9
Communication	4.8	-	4.8
Cons. Cyclical	7.8	-	7.8
Cons. Non-Cyc	10.3	-	10.3
Energy	4.1	-	4.1
Financial	39.5	-1.0	38.5
Industrial	6.3	-	6.3
Technology	0.9	-	0.9
Utilities	0.2	-	0.2
Total Equity	95.8	-1.0	94.8
Total Cash			5.2
Total Equity and Cash Exposure			100.0