

K2 Asset Management

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KSM - K2 Australian Small Cap Fund (Hedge Fund) Monthly Report - 31 October 2016

Australian Small Cap Market Review

The K2 Australian Small Cap Fund returned -1.48% for the month of October.

Bond yields across the globe have risen considerably in recent months given the uncertainty surrounding both the outcome of the US election and the US interest rate cycle. During the month, the Australian 10 year bond yield rose by nearly 50bps which is the largest rise since May 2009, and provided the catalyst for a repricing of risk across equity markets.

The Small Ordinaries Accumulation Index fell -4.7% for the month, with 1 in every 4 stocks in the Index down over 10%. In particular, investors fled expensive Industrial companies, in search of companies which appear to offer more valuation support. This thematic was not confined to the small cap investment landscape.

The top contributors to the Fund for the month were MotorCycle Holdings, Corporate Travel and Money3 Corp. While Baby Bunting, Updater and Smart Group were the largest detractors.

Portfolio Insight: Idea Generation & Stock Selection

The volume and velocity of information in the world today, especially in financial markets, continues to increase exponentially. Deciphering the noise and understanding key facts is critical for the idea generation process. We generate ideas from numerous information channels, however getting out and meeting with companies and their management is one of the most effective ways for us. In addition to providing important insights into the performance of their own business, management can also share their views on the industry in which they operate and how the industry is evolving. It also gives us the opportunity to cross examine competitor behaviour and validate information from other sources.

Filtering these ideas into the best investment opportunities is the next important part of the process. Companies which are 'cheap' can be easily identified using quantitative screens. However, understanding why they are cheap and, more importantly, identifying a catalyst which may unlock this value is the critical part of the investment process. Drawing on K2's 17 years of investment experience and using a combination of top-down industry research along with bottom up fundamental analysis we determine the best opportunities. Meeting company management also plays a key role in the investment process as does establishing expectations from the investment community. Identifying a catalyst can come in many forms and over various time frames. However, the focus will always be on what specific event/s that will drive the market to re-rate the stock. Companies can remain undervalued for long periods and therefore timing will also play a key part of our investment approach.

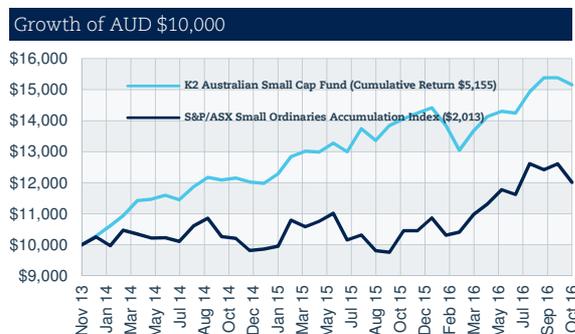
Outlook

Due to the low growth environment in which corporates are operating and the structural challenges facing many industries, investors have been drawn down the market cap spectrum in a search for earnings growth. This pushed valuations in some corners of the market to extreme levels and brought a new type of investor to small caps; Growth At Any Price (GAAP). Given the liquidity risks and earnings volatility inherent in small cap companies, investor conviction is currently being tested as some of the 'market darlings' have suffered material share price declines. Some have been as a result of earnings disappointment and some have just de-rated from extreme valuation levels. Due to the nature of small cap investing, we would expect this will continue in the short term, and we are looking for opportunities this may provide to deploy funds into quality companies at the right price.

Top 5 Stock Contributions - October

Largest	9 Spokes International Ltd, Corporate Travel Management, Money3 Corp Ltd, Motorcycle Holdings Ltd, Think Childcare Ltd
Smallest	Baby Bunting Group Ltd, SmartGroup Corp Ltd, Tech Mpire Ltd, Updater Inc, Vita Group Ltd

Performance to 31 October 2016 (net of fees)	
1 Month	-1.48%
3 Months	1.53%
6 Months	7.26%
1 Year	7.79%
Since Inception (pa)	15.32%



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)	
NAV Per Unit:	A\$2.66
Fund Size:	A\$22.8m
Start Date:	01-Dec-13

Top 5 Holdings	Sector	%
Medical Developments International	Cons. Non-Cyc	4.8
Baby Bunting Group Ltd	Cons. Cyclical	3.9
Updater Inc	Technology	3.9
Motorcycle Holdings Ltd	Cons. Cyclical	3.6
AMA Group Ltd	Cons. Cyclical	3.4

Sector Exposure %			
	Long	Short	Net Equity
Basic Materials	1.2	-	1.2
Communication	8.0	-	8.0
Cons. Cyclical	22.7	-	22.7
Cons. Non-Cyc	25.3	-	25.3
Energy	0.8	-	0.8
Financial	20.2	-	20.2
Industrial	5.8	-	5.8
Technology	8.8	-	8.8
Total Equity	92.8	-	92.8
Total Cash			7.2
Total Equity and Cash Exposure			100.0

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