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K2 International Equity Update
Quarterly Report - 31 December 2017

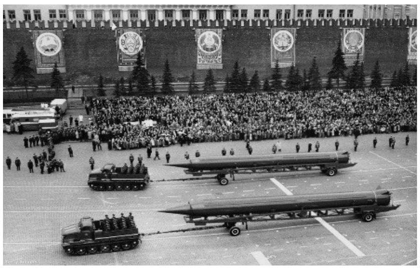
Market Review

The K2 Select International Absolute Return Fund gained 4.3% for the quarter ended December 2017.

Global equity markets continued to surge higher over the last 3 months spurred on by the promise of US tax reform finally passing through both houses of parliament. After an extended game of political ping pong there is now light at the end of the tunnel. While full details are yet to be announced as we go to print the final storyline could still play out like a John Grisham thriller with a few more twists in the tail.

On the political front, investors are becoming increasingly immune to the sensationalist doomsday headlines. The UK has survived Brexit, so far. The US has survived Trump and possibly even thrived if low unemployment rates, sky high stock markets and a falling USD are your benchmarks. European elections of 2017 were largely uneventful. And finally, Kim Jong-Un has not done anything silly.

Eric Schlosser's book, "Command and Control", is a fascinating insight into the history of nuclear weapons in the US and globally. Schlosser takes us back to the great arms race between America and the Soviet Union beginning in the 1950's. Broadly speaking, the general consensus from military and political leaders was that the real power of nuclear weaponry was in possessing them and making sure that your opponents are aware you have them, NOT actually using them. History may not always repeat but it does often rhyme and during the quarter we met with experts in this field including Stephen Hadley (21st US National Security Advisor) and Max Baucus (US Ambassador to China 2014 – 2017).



Soviet Union show of military strength in Red Square in 1961

In a further nod to political stability, Putin's main rival Alexei Navalny has been ruled ineligible to run in the March 2018 Russian general election because of a prior fraud conviction and is now illegally calling for Russians to boycott the poll. Either way we expect Mr. Putin to win easily, again.

We met with a number of interesting companies over the last 3 months. From European financials where big data and cross-selling are all the rage to Italian tower companies currently experiencing heightened levels of corporate activity. We also observed the influx of Japanese REIT's continue with their impressive occupancy rates and rental increases.

Start Today's "ZOZOSUIT"

A more interesting meeting was held with management of leading Japan online fashion retailer Start Today. In partnership with New Zealand based StretchSense, they have a developed a Cathy Freeman style suit which is provided to customers free of charge. The suit's in-built sensors calculate precise body measurements by collecting 15,000 data points and transmitting the results to your smartphone app. The suit was launched in Japan on 22nd November with a staggering 230,000 units ordered in the first 10 hours. Through their own private label Start Today will be able to offer the latest fashion trends semi tailored to customer dimensions. The volume of product returns should also reduce significantly. Currently trading on a FY19 expected PE of approximately 40x we feel that the good news is already in the price and will patiently wait for a more attractive entry point.

Oil increased a further +16.9% (WTI) in the quarter boosted by pipeline disruptions and shrinking stock piles. OPEC met at the end of November, agreeing unanimously to extend production cuts through until the end of 2018.

US equities continued along their upward trajectory in Q4. The tech heavy Nasdaq rallied +7.0% once again overshadowing the large cap S&P 500 Index return of +6.1% but only just. US 10-year treasuries closed the quarter at 2.41%, as bond prices declined with news of tax cuts and increased government spending expected to drive larger budget deficits.

The major European indices mostly managed to squeeze out positive gains for the quarter as domestic economic growth becomes more persistent and central banks remain accommodative. In the UK, Brexit negotiations continue and despite a few speed bumps along the way should eventually reach a satisfactory conclusion for all parties. We feel it is important to focus more on the destination and not so much the journey. In Europe, Spain provided the majority of the drama with Catalonia's push for independence. This would be like Queensland seeking independence from the rest of Australia.

At the index level, UK's FTSE 100 rose +4.3%, Germany's DAX advanced +0.7% and the French CAC declined -0.3%.

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Asian markets were generally stronger again in Q4. This follows strong performances in both Q2 and Q3. Hong Kong advanced a further +8.6% as solid corporate earnings and global fund flows lay the foundations for investor confidence. Big brother China wasn't drinking the Kool-Aid, falling –1.3%. Korea gained (+3.1%) while Australia broke free from the shackles up +6.9% as defined by the ASX 300. Japan increased +8.5% (TOPIX) as the Yen held flat vs the USD. The AUD closed December at USD0.781 US cents, down -0.3% for the quarter.

Outlook

As we draw the curtains on 2017 we take comfort in the belief that the world might actually be in better place than expectations at this time last year. Synchronised global growth is the rising tide lifting all boats supported by a continuation of accommodative monetary policy in all major regions. Unemployment rates remain at multi year lows and bad debts across the banking industry are almost negligible. Throw in a global tax cut war and the prospect of increased fiscal spending and we have the recipe for a robust setup into 2018.

However, as prudent fund managers we focus on company fundamentals and are constantly stress testing our assumptions. We harbour growing concerns that the market tolerance for risk is becoming a bit too complacent, ranging from the sharp rise in unregulated consumer credit to Bitcoin. The VIX index, a measure of 30-day implied S&P 500 Index option volatility, remains at record lows of approximately 10%.

Putting all this together our disposition has improved to that of cautious optimism as we gain comfort from the markets ability to successfully navigate any short-term disruptions and soldier on to successive new highs.

Moving into 2018, greater uncertainty surrounds the US interest rate landscape with the market expecting anywhere from one to three 25 basis point increases over the next 12 months. With the onset of quant tapering we enter unchartered waters and therefore anticipate an extremely slow burn from central bankers to avoid any unintended consequences.

In Europe, growth rates are being revised up allowing investors to embrace the relatively positive economic outlook for the region. We continue to selectively add European domiciled names to the portfolio.

Reflective of a more optimistic outlook for global equities we have increased net equity exposure position to approximately 84% invested. In addition, short portfolio positions currently total 4.0% as we seek alpha opportunities in structurally challenged names with little valuation support. We have decreased our AUD hedging to zero to reflect our relative negative stance on Australia and the Australian Dollar compared to the rest of the world.

Portfolio Insight: DBS Group Holdings Ltd

DBS CEO Piyush Gupta

With improving global economic growth and a yield curve that can only steepen from its current flat structure, we believe banks have significant tailwinds to appreciate over the next 12 to 24 months.

However some banks are more equal than others. One such bank that we believe shows a clean pair of heals to its competitors is DBS, a leading south-east Asian banking franchise based out of Singapore. What really excites us about DBS is its global best in class technology platform which is considered the regional leader in its rollout of digital capabilities. In carrying out our channel checks, we met with ING, the Dutch bank, who is considered by many as having the best technology / Fintech platform of any bank globally. In ING's own words, the only bank whose technology platform compares to ING is DBS and they are the clear leader in Asia.

DBS will benefit from rising global interest rates and a steepening yield curve in 2018 which should see net interest margins expand. Current focus on growing the wealth management division will increase recurring revenues thus providing a more stable income that requires less balance sheet capital. Trading on an undemanding forecast FY18 expected PER of 11.5x with forecast EPS growth of 18.7% p.a. over the next 2 years, DBS represents a significant position in the Fund.