



K2 International Equity Update Quarterly Report - 30 September 2017

Market Review

The K2 Select International Absolute Return Fund gained 3.20% for the quarter ended September 2017.

In the face of mounting global geo-political concerns equity markets continue to exhibit a steadfast resilience. The war of words between US President Trump and North Korean supreme leader Kim Jong-un shows no signs of abating. With his complicated plans for the development and deployment of weapons of mass destruction we suspect that Kim Jong-un might suffer the same fate as Snowball the boar on the Manor Farm in George Orwell's classic novel, Animal Farm, first published in 1945. Formerly one of the rebellion's most valuable leaders, Snowball is ultimately chased off the farm by Napoleon's dogs no less and forever used as a scapegoat for the animals' troubles.

Speaking with the cynicism and pessimism of Benjamin, Orwell's donkey, we take the view that for Trump this is merely a feeble attempt to take the world's gaze away from his own internal problems. As he approaches nine months in office we are still waiting for any meaningful developments on healthcare, tax reform, etc.

Based on a visit by a K2 portfolio manager to the DMZ, a 4km wide stretch of no-man's land between North and South Korea, we believe that military action is highly unlikely. A highlight of the tour was an inspection of the tunnels supposedly dug by North Korea and apparently to be used to invade South Korea...with tanks. For a tunnel, the level of sophistication is excellent and might work well if escaping from prison, but to move an army – impossible.

Full credit to investors who have so far been able to look past the rhetoric and attempts at intimidation to focus on underlying corporate earnings, which continue to impress.

We had a number of interesting company meetings over the last 3 months. From Japanese office REITs who are currently running at 97%+ occupancy rates and high single digit rental increases, to global commerce facilitator eBay who are about to release new photo search technology. For example, simply upload a picture of the bonsai plant you always wanted and with the click of a mouse "they" will find a selection of the closest matches for your browsing pleasure.

"And Up through the ground came a bubbling crude. Oil that is! Black gold! Texas Tea!" up +12.2% in the quarter as stock piles shrink and OPEC continues to say and do the right things.

US equities continued along their upward trajectory in Q3. The tech heavy Nasdaq rallied +5.9% once again overshadowing the large cap S&P 500 Index return of +4.0%. US 10-year treasuries closed the quarter at 2.33%, after hitting an intra-quarter low of 2.04% in early September.

The major European indices all ended the quarter in positive territory as political uncertainty subsides. In the UK, Brexit talks are still ongoing but are certainly not looking like the train wreck most experts were predicting. While in Europe, Chancellor Merkel was returned to power with a comfortable majority. At the index level, UK's FTSE 100 rose +0.8% while the French CAC and Germany's DAX both increased +4.1%.

Asian markets were generally stronger in Q3. Following a strong performance in Q2, Hong Kong advanced a further +7.0% as strong corporate earnings and global fund flows underpinned investor confidence. Big brother China was slightly more subdued, up "only" +4.9%. Korea (+0.1%) lagged as the country to be most heavily impacted from any fallout north of the border. Australia, beating to its own drum, declined by -0.5% as defined by the ASX 300. Japan increased +3.9% (TOPIX) as the Yen held flat vs the USD.

Outlook

The September quarter saw global equity markets continue their extended period of excessively low volatility. The VIX index, a measure of 30-day implied S&P 500 Index option volatility, remains at record lows below 10%. We maintain our cautious disposition in spite of the market's uncanny ability to successfully navigate any short-term hiccups and soldier on to successive new highs. Like enjoying a game of bocce in the backyard when suddenly the birds stop chirping and everything goes eerily silent...

As we enter the final quarter of 2017, our expectation of a further 25 basis point interest rate rise in the US has largely been incorporated by markets. Greater uncertainty surrounds the landscape for 2018 however, given the majority of Federal Reserve members will be vacating their seats, including the chairperson. Uncertainty surrounding quantitative tapering and to what degree it may or may not happen together with any associated impact on interest rates will persist well into the new year.

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The lower for longer interest rate environment has continued to provide valuation support for the market helped by solid earnings growth, albeit off a very low base. If rates do start to rise in any meaningful way valuation support will quickly disappear and earnings growth will need to pick up the slack. The jury is still out.

On the flip side, Financials are a significant beneficiary of rising rates and when combined with buyback support and increased dividends we continue to increase our exposure to that part of the market.

In Europe, with elections decided, investors can embrace the relatively positive economic outlook for the region aided by accommodative fiscal policy and government spending. We continue to selectively add European domiciled names to the portfolio although, similar to the US, value is becoming harder to find.

Reflective of a more cautious outlook for global equities we maintain a net equity exposure position of approximately 71% invested. In addition, short portfolio positions currently total 3.4% as we seek alpha opportunities in structurally challenged names with little valuation support.

We have increased our AUD hedging to 47.1% and increased our Euro and JPY positions to 18.5% and 7.1% respectively to reflect our more neutral stance.

Portfolio Insight: Honma Golf

Founded in Japan over 50 years ago, Honma is recognised as one of the most prestigious luxury brands in the golf industry. Through a combination of superior craftsmanship and unrivalled product quality Honma has established itself as an iconic golf brand with 33 professional players across Asia currently affiliated with "Team Honma."

Wanting to make a positive impression on the newly elected US President, when Japanese Prime Minister Shinzo Abe visited America in late November 2016 he gifted Mr. Trump a gold plated Honma Beres S-05 driver valued at US\$3,755. Trump made good use of the driver in February this year when he and Abe played golf together in Florida.

Future growth opportunities for Honma include expansion into the lucrative US market and improved product creation and marketing of apparel and accessories. Honma offers an attractive risk/reward profile underpinned by a non-demanding 1-year forward PE of 12.4x.