K2 Asset Management
Level 32, 101 Collins Street Melbourne Victoria 3000 Australia
Telephone 61 3 9691 6111 **Facsimile** 61 3 9691 6170
Website k2am.com

K2 Australian Equity Update
Quarterly Report - 30 June 2018

Market Review

The K2 Australian Fund returned +4.0% for the quarter and +13.1% for the Financial Year ending 30 June 2018. This return was achieved with an average cash balance of 21.5% for the year and in line with the Fund's targeted through the cycle return of 10%+ p.a.

After the extreme volatility of the first quarter of 2018, the Australian All Ordinaries Accumulation Index delivered three consecutive positive months providing a +13.7% total return for the 2017/18 Financial Year. The second round of public hearings for the Financial Services Royal Commission occurred in April and garnered much attention. Market participants were broadly concerned that banks had been lending irresponsibly and that further regulatory burdens were inevitable. Sell side banking analysts were quick to assume that a credit crunch was probable and a significant housing drawdown was ultimately unavoidable. At its worst point during the quarter, the banking sector underperformed the broad market by 8%. By quarter end the underperformance of the banking sector narrowed to 4.4%. The K2 Australian Fund has been underweight the 4 major banks and has instead held long term positions in Macquarie, CYBG, Challenger and Suncorp.

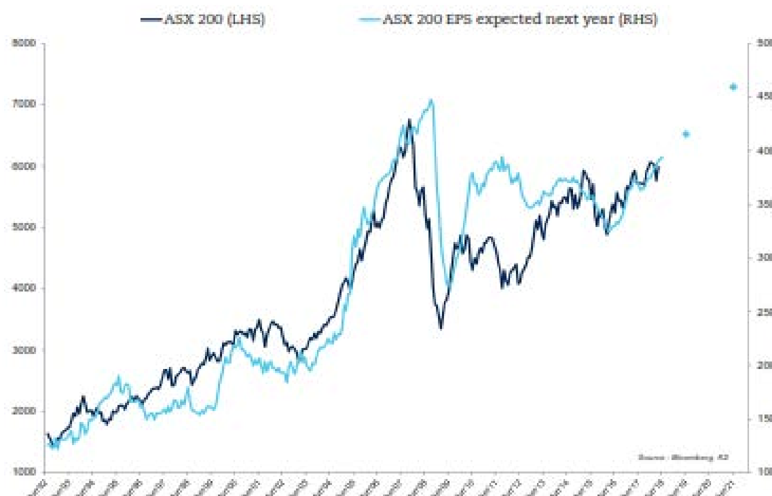
With volatility becoming ever more prevalent, the cash allocation and short equity component of the portfolio were utilised to help offset the uptick in market volatility and provide a greater degree of capital protection if the markets were to see a significant correction. Capital protection strategies including short equity slightly detracted from performance during the quarter. The Fund held respective average cash and short positions for the quarter of 14.9% and 5.5%.

At a sector level the best contributor to performance was an overweight position in Basic Materials. The Fund also benefited by being overweight in the energy sector. At a stock level the top 5 positive contributors were BHP, Macquarie, Woodside Petroleum, Alumina and Rio Tinto.

Outlook

We remain positively disposed to equities yet acknowledge we are deep into an extended positive economic cycle and need to remain vigilant on valuations and capital preservation. We believe corporate profitability growth will gain momentum aided by tax cuts, fiscal stimulus and increased capital expenditure. EPS growth for the market should be more sustainable as growth is unlikely to be diluted by secondary raisings. Given strength in corporate balance sheets we are of the view that surplus capital will increasingly be retired.

Inflation pressures are gradually building with labour constraints likely to lead to eventual higher wage growth. Tradeable inflation is also likely to rise in the coming months given the strength in petrol prices. The RBA's next move is likely to see rates up not down, yet given current weakening house prices and tighter credit conditions the RBA can remain patient. As cash rates eventually rise, growth improves and the recovery matures we expect the PE of the market to decline. We are targeting a PE of 15x versus the markets long run average of 14.5x and the current level of 15.7x. We expect EPS growth momentum to continue over the next 3 years (see chart below).



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Sector in Focus: Oil

The oil price (Brent) has rallied over 150% from its low point in January 2016 to just under USD80 at the end of June. The recovery has been driven by a combination of broad based fundamental demand growth together with supply side constraints ranging from OPEC cuts to geo-political trouble in major oil producing states. Furthermore, US shale production, which was largely expected to fill the hole left by OPEC, is showing signs of growing pains. Commercial inventories are being rapidly depleted and the market remains extremely tight with further risks to supply. Even President Trump's best efforts to encourage Saudi Arabia to increase production, hoping for a lower oil price, had the exact opposite effect.

Significant upgrades to consensus oil price forecasts have just begun and the sector is re-rating accordingly. We believe that favourable industry dynamics will persist with the following catalysts:

- High degree of compliance to announced cuts from OPEC and "friends" with recent messaging suggesting less than expected output increase
- Broad based global demand growth running above expectations
- Saudi Arabia seeking USD80 oil price to support imminent Aramco IPO
- Iranian sanctions and political turmoil in Venezuela
- US shale, considered to be the world's marginal producer, is logistically constrained, evidenced by a stabilising rig count
- Capex discipline for the big oil companies still scarred from 2014 price collapse

The K2 Australia Fund has exposure to the oil sector through a holding in Woodside Petroleum. Woodside is our preferred exposure to the rising oil price due to its attractive valuation, strong balance sheet, high dividend yield and rising production profile. Woodside is also a major beneficiary of the significant rise in LNG prices, via its substantial Australian LNG assets. The spot LNG price is currently USD10/mmbtu up over 100% from nearly a year ago driven by a surge in Chinese imports. China's demand is driven by structural reforms on clean energy and the LNG supply glut is being rapidly absorbed. Woodside is the only major Australian energy company with meaningful production growth over the next 3 years and has a balance sheet to support this growth.

The K2 Australian Small Cap Fund has exposure to the oil sector through holdings in MMA Offshore Ltd and Sundance Energy. Both of these companies experienced the devastating effects of being too geared at the wrong time in the commodity cycle and have spent the last three years rationalizing asset bases and recapitalizing. Now, with ample liquidity and re-energised management teams, these companies are well positioned to deliver strong shareholder returns from the improved end market.

MMA Offshore Ltd has a fleet of vessels that is massively leveraged to rising capital expenditure from global oil and gas majors, who are looking to arrest their volume decline.

Sundance offers size, scale and aggressive earnings growth, with a material drilling program underway.