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K2 Australian Equity Update
Quarterly Report - 31 March 2018

Market Review

The K2 Australian Absolute Return Fund returned -1.23% for the quarter ended 31 March 2018.

Volatility returned in Q1 2018 as markets began paying attention to political risks both domestically and abroad. After ripping higher in January in response to December's passing of US corporate tax cuts, February provided a timely reminder of the power of markets. On 6 February an ETF blow up of the 'XIV' product tradable in the US sent the VIX Index soaring above 50 and global markets abruptly lower. After regrouping, lows were re-tested in March as President Trump stayed true to his word and imposed strong tariffs on China. Amongst this volatility, we saw the first of new Fed Governor Jerome Powell. US rates were increased 25 bps as expected, while also increasing the expectation of further rate rises in outer years. Domestically, news flow was dominated by negative accusations within the banking sector as the Royal Commission began. Although headlines to date have been damning, sector valuations are becoming attractive with the negativity arguably now in the price. The RBA remained on hold at 1.50%, while the AUD fell 1.7% to 76.79 US cents.

In a common theme of recent years, Healthcare (+6.1%) and Technology (+0.7%) were the best performing sectors. The Telco sector (-12.8%) struggled again printing poor results, while the NBN rollout fell further behind schedule. Utilities (-8.3%), Energy (-7.7%) and REITs (-7.3%) were also notable underperformers as rising bond yields hit stocks with interest rate sensitivities.

Outlook

The sudden volatility spike in early February was a reminder of the vulnerabilities of poorly structured products. The reverse VIX ETF (XIV) was a pure momentum product that was designed to perform when market volatility was low. During 2016 the VIX index averaged 15.8 and the XIV ETF rose 81%. In 2017 the VIX index averaged 11.1 and the XIV ETF returned 187%. As a result of this significant performance, the XIV ETF was vulnerable to a meaningful drawdown if volatility changed direction. It was interesting that during the first 6 days of February bond yields rose, equity trading volumes were low and interest rate risk premiums expanded. This cocktail of events led to a sharp spike in the VIX. The XIV ETF subsequently fell by 97% in 10 days and was promptly liquidated. Typically, when market participants use asset prices to create "risk" signals, investment flows tend to migrate from weak hands to strong hands. By way of example, since the XIV ETF was liquidated, the average 10 year bond yield for the G7 nations has declined by more than 20 basis points and yield curves have dropped to decade lows. We believe that long bonds are now over-bought. We are of the view that over the coming year or two global growth and inflation will most likely surprise on the upside. We also anticipate that the supply of long bonds will be considerably higher than the demand and as a result bond yields will ultimately rise to reflect this imbalance.

During this period of increased volatility we have maintained an average cash balance of 17%. We have been gradually increasing our short exposure and it is now sitting around 5%. Our long exposure has gravitated towards attractively priced, more liquid positions and the number of positions have dropped from 57 to 45. The Fund's holdings are expected to deliver on average 9% p.a. EPS growth over the next three years, an ROE over 13% and are priced on 14.4x next year's earnings. Our exposure is still skewed towards basic materials and non-major bank financials. We have been slowly increasing our exposure to the four major banks but our weight is still less than 10%.

The All Ordinaries Accumulation Index declined 3.7% this quarter and the K2 Australian Fund protected its investors from the full draw down delivering just 32% of the weakness. This performance is consistent with our philosophy; we aim to participate with equity market gains when growth opportunities are available. But importantly we strive to preserve these gains when market conditions change. Our investment style can therefore be described as variable beta. Since the inception of the K2 Australian Fund 19 years ago the Australian equity market has delivered 24 negative quarters and the average decline has been 5.7%. The K2 Australian Fund has on average delivered just 51% of these drawdowns.

Portfolio Insight: BHP Billiton Limited - K2 Australian Absolute Return Fund

K2's bullish view on resources remains intact. The Fund took advantage of short-term price weakness in BHP Billiton Limited (**BHP**) during the quarter as uncertainty prevailed following President Trump's protectionist tariff proposal on trade with China. Concerns of a trade war between the US and China, which our analysis suggests will only have a minimal impact on both countries GDP based on what has been announced, allowed us to increase exposure to the "Big Australian" at attractive prices. BHP has been a core holding over the last 24 months and is currently the Fund's single largest investment. Our conviction has grown as we move into a more reflationary environment coupled with a backdrop of the strongest period of synchronised global growth in nearly a decade.

Resources tend to perform best in the later stages of economic cycles as equity bull markets mature. The US Federal Reserve is in the stages of a tightening interest rate environment leading to rising long bond yields and building inflationary expectations. Commodity prices act as a natural hedge against inflation, setting the scene for strong performance.

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Since the 1970's there has been four major periods of rising interest rates and rising bond yields during which resource share prices and PE ratios have re-rated strongly. In fact, on each occasion, BHP's PE has re-rated to a premium of between 50% and 100% to the broader market. Currently BHP trades at a slight discount to the market at a PE of 13.8x 2018 earnings. K2 believes this discount will unwind and move to a significant premium as investors' confidence improves on the sustainability of recent strength in commodity prices. We believe the longer spot prices persist, the more likely the sector will re-rate.

BHP offers compelling valuation support at current levels and will benefit from continued consensus earnings upgrades that still reflect below spot commodity prices. BHP has significantly reduced its cost base and is well positioned to further optimise their existing asset base to increase production from their existing infrastructure at a lower cost. A major short-term catalyst will be the sale of US onshore shale oil assets. A price in excess of USD10b is not unrealistic and our sources point to over 40 parties having entered the data room to conduct due diligence on the assets. Given recent oil price strength contested bidding cannot be ruled out. In our view, this outcome is likely to have a material positive share price impact as it removes a cash consuming non Tier 1 asset and allows BHP to return surplus capital back to shareholders. BHP remains in an upgrade cycle.

Portfolio Insight: Janison Education Group Limited - K2 Australian Small Cap Fund

Janison Education Group Limited (**JAN**) is a global technology company that provides online learning and digital assessment platforms. The K2 Australian Small Cap Fund invested at IPO in December 2017 and it has been a strong performer for the fund since listing (+55%).

JAN operates two businesses. The first, known as Learning, which provides a corporate learning platform for major corporate and government clients and the second, known as Assessment, which provides a digital assessment platform for the provision of digital exam authoring, testing and marking.

JAN provides these platforms for a wide range of enterprise clients such as Westpac, Ramsay Healthcare, Government departments and tertiary and vocational institutions both locally and globally. The most widely recognised of their assessments is NAPLAN, which has been developed over the past 5 years and is being rolled out for Years 3, 5, 7 and 9 across Australia.

With high speed internet availability and the proliferation of personal computers and mobile devices, there is a new generation of students and employees emerging. Digital assessment and online learning is still considered relatively early in its lifecycle. As technology continues to evolve, adoption rates are beginning to increase and this represents huge opportunities for those companies which can offer a trusted online solution. JAN has been operating in this space for over 20 years and with platforms already entrenched in workplaces and education departments, the company is well placed to benefit from this rapidly growing industry.

Given the strong outlook for online education along with JAN's market leading position and highly scalable business model, the company is expected to deliver strong profit growth and cash flows over the coming years. With an experienced management team and net cash on their balance sheet, the company is well funded and well-resourced to take advantage of the growth opportunities which lie ahead.