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K2 Australian Equity Update
Quarterly Report - 30 September 2017

Market Review

The K2 Australian Absolute Return Fund returned 1.80% for the quarter ending 30 September 2017 while the S&P/ASX All Ordinaries Accumulation Index returned 1.00%.

Struggling for direction and underperforming global markets, Australia traded within a remarkable 3.1% range for the quarter. A mixed reporting season saw cautious corporate commentary, with any misses severely dealt with by the market. Geopolitical noise continued as North Korea fired five missiles, including two over Japan, and tested a hydrogen bomb. Markets continue to look through these developments provided the relationship between 'Rocket Man' and the 'Dotard' remains verbal. China attempted to distance itself as focus shifted to political and economic stability ahead of October's 19th National Congress. The Federal Reserve guided to October as the start date for unwinding their $4.5 trillion balance sheet. Whether this is like 'watching paint dry' remains to be seen. Bond yields ripped higher in response, placing further pressure on the yield centric Australian market. Commodities benefitted from this rotation, while lithium stocks exploded higher as the shift to electric vehicles gathered momentum. The RBA left rates on hold at 1.5%, while the AUD was 1.9% stronger at USD0.7834.

Energy (+6.2%) and Materials (+4.8%) were the best performers in what was an aggressive cyclical rotation. Telcos (-18.7%) delivered poor results as competitive pressures bit and TLS cut their forward dividend by 29%. Bond proxies also struggled as Utilities (-7.2%) and Healthcare (-6.2%) underperformed.

Outlook

Back towards the end of the March 2017 quarter the K2 Australian Fund started to reduce net equity exposure. We were concerned that valuation metrics had reached a point where prospective market returns would be at best pedestrian. We were also mindful that the Australian equity market was having difficulty generating profit growth. Subsequently over the past 6 months the ASX 200 Accumulation Index has declined 1%. As the market has weakened the K2 Australian Fund has gradually been increasing net equity exposure. We are finding some opportunities to invest in businesses at more attractive prices and we are sensing that growth prospects are becoming more entrenched.

From a top-down perspective we believe that the Australian economy has developed stable foundations for future growth. The employment market continues to strengthen, business confidence remains buoyant and consumer sentiment appears to be improving. Offsetting these positives are concerns that Australian households are generally carrying too much mortgage debt at a time when wage growth is negligible. The Reserve Bank of Australia has been prepared to keep interest rates low in an effort to support the economy. The RBA is concerned that as households look to repair their balance sheets, there could be a serious correction if any negative economic shock should occur. Hence it is likely that the RBA will be happy to stay behind the curve in regard to its objective of maintaining a rate of inflation within a 2-3% band. Interest rate rises will occur but the trajectory will be shallow.

With this backdrop we would expect to see indicators for Australian "animal spirits" gradually improve. Non-mining capex for the June quarter hit a record high of $21.1 billion and was 3% above last year. Non-passenger and SUV new vehicle sales for August were over 23,000 which surpassed the prior peak during the mining boom. The employment component of the National Australia Bank Business Survey is finally back to pre GFC levels. In addition, during the June half there was a record 131,000 new company registrations in Australia, 3% above last year.

The missing ingredient is investor confidence. We have been surprised that, according to the WBC/Melbourne Institute Survey, the share market is still seen as the worst place for savings and that this level of belief is on par with March 2009. This would partly explain why the number of margin loans in Australia has halved since the GFC and the value of margin loans outstanding has dropped 73% to just $11.7 billion. This lack of conviction in equity markets has seen a 5%pa decline in the average daily value of trade on the ASX since the GFC. Ultimately this has led to a stagnation in the number of companies listed on the ASX; at present there are 2,245 Australian listed companies which is just 1% more than in 2009.

We believe that sentiment towards the Australian equity market will improve. Interestingly throughout the 20 years leading up to the GFC, average daily trade value on the ASX consistently grew at 20%pa and the number of listed companies grew by 2.5% every year. Given we are finally seeing more sell-side analyst upgrades than downgrades, this could be the precursor to a greater level of trading activity. The Australian equity market also offers a yield that is 110 basis points higher than developed market peers. In fact the yield of the Australian equity market is fast approaching Russia, the highest yielding market in the world. Finally, we are mindful that the December quarter in Australia tends to be the best performance period of the year. Over the past 20 years, the All Ordinaries Accumulation Index has risen 80% of the time in the December quarter and the average total return has been 3.8%.

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Portfolio Insight: Macquarie - K2 Australian Fund

Macquarie is a globally diversified financial group with over 13,000 employees operating in 27 countries. Macquarie has established leading market positions in sectors such as infrastructure, resources and commodities, energy and real estate. The group tends to balance opportunity and accountability so, as a result, a strong risk management framework is embedded across all operating segments. This framework has helped Macquarie deliver 48 years of profitability and we are confident that this trend will continue in the future.

One important facet of the Macquarie business model is its remuneration arrangement that is designed to attract and retain high-performing staff. Macquarie tends to pay staff relatively low base salaries and places greater emphasis on performance-linked remuneration. Macquarie's profit share pool is calculated as a proportion of after tax profits after taking into account the cost of capital. Accordingly, Macquarie tends to have a cost-to-income ratio below that of its global peers. Despite this Macquarie has a low staff turnover rate. The 12 member Executive Committee has an average tenure of 23 years. In addition 43% of the 3,000 Director-level staff members have been with Macquarie for more than 10 years and, importantly, the voluntary turnover rate last year was just 6.8%.

Over the coming years we anticipate that most of the major developed countries will be focussed on delivering infrastructure upgrades. These long horizon capital projects require complex funding structures and Macquarie is globally recognised as a specialist provider of these services. Macquarie also generates significant profitability from its capital market facing businesses which are typically leveraged to broad global growth which we believe will improve over the coming years. Hence we feel that Macquarie is well positioned to generate considerable profits over the foreseeable future. Valuation metrics are also reasonable; Macquarie trades on 13.5x next year EPS versus its long run average of 14.5x and offers a compelling dividend yield of 5.4%.

Portfolio Insight: Synlait Group - K2 Australian Small Cap Fund

K2 first invested in Synlait Milk (SML NZ) at IPO in July 2013. As a core holding in the K2 Small Cap Fund, SML has delivered strong returns for unitholders. Synlait is New Zealand's fourth largest milk processor and supplies dairy ingredients to globally branded companies. SML is the exclusive supplier of infant formula to a2Milk and has supply agreements in place with US based Munchkin Baby Supplies and China's New Hope Group.

Initially we were attracted to Synlait's positive industry dynamics, improving earnings profile and highly rated management team. Our fundamental analysis suggested this outlook along with their competitive position which was not fully reflected in the company's valuation.

A fully integrated supply chain and stringent food safety standards make barriers to entry extremely high for this industry. Increasing demand from Chinese consumers, particularly for infant formula, are driving a structural shift in customer demand. To capitalise on this, Synlait invested substantial capital into production capability to increase processing capacity. Successful execution of this strategy would see a considerable uplift to earnings and returns as the demand from customers, particularly a2Milk, filled this new capacity. Having met management on numerous occasions, and given their substantial shareholding and track record, we were confident in their ability to execute their strategy. Against this backdrop, we felt the company was undervalued relative to the risk and opportunities which lay ahead.

Four years post our initial investment and having successfully executed their expansion strategy, Synlait is on the cusp of substantial earnings growth. The pathway to this point has not been linear and management has done an excellent job overcoming the challenges along the way. Not surprisingly, given the visibility of earnings growth on offer, the company has re-rated substantially over the past 12 months and now represents, in our own view, a more appropriate valuation. While we remain optimistic for the company's outlook, we have reduced the size of the position to appropriately reflect the risk/reward proposition going forward.