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K2 International Equity Update

Quarterly Report - 30 June 2018

Fund Review

The K2 Select International Fund returned -0.25% for the quarter ended 30 June 2018.

The Fund targets a through the cycle return of 10% p.a., by limiting fund drawdowns in non-favourable market conditions, through the use of holding cash, short equity positions and active currency management. This strategy allows the Fund to protect capital and compound returns off a higher base following market pull-backs.

After the extreme volatility of Q1 2018, global equity markets entered a marginally more subdued pattern, with the months of April and May showing positive returns while June was flat. US reporting season once again proved to be strong with corporate earnings beating the streets estimates and upgrades ensuing. That being said, markets placed a greater importance on the outlook statements, where companies were generally more guarded in their narrative due to rising interest rates and geopolitical events. Europe provided journalists plenty of fodder for the columns, with Italian politics and subsequent repricing of its sovereign risk sending a shudder through world markets.

The largest determiner of performance over the quarter was long equity, impacted by the Fund's material exposure to Chinese related companies which suffered during June as markets revisited a "risk-off" period. Regionally, long equity detracted in Europe ex UK and Asia, while the UK and the US aided performance. Stock selection within long equity was boosted by the Fund's exposure to Resources and Oil & Gas. Holdings including BHP Billiton, BP Plc, Rio Tinto and Hess Corp all benefited from high commodity prices. Longs that detracted included Chinese insurance behemoth Ping An and US investment bank Goldman Sachs.

With volatility becoming more prevalent, the cash allocation and short equity component of the portfolio were increased to provide a greater degree of capital protection in the event of a market correction. During the quarter, capital protection strategies including short equity detracted from performance with positions in both the US and Australia moving in the wrong direction. At the end of the quarter, capital protection strategies represented c. 10% of the portfolio. At the end of the month, the Fund is 10% hedged back to the AUD. Currency provided a tailwind to performance in Q2 2018 as the AUD declined relative to most major currencies.

We met with a number of interesting companies over the last 3 months including Banco Mediolanum of Italy, whose asset management business continues to defy gravity and European low cost carrier easyJet, who are rapidly gaining market share from the incumbent full service airlines.

Oil increased a further +14% (WTI) as US stockpiles continue to decline as OPEC and "friends comply with announced production cuts and recent messaging suggesting less than expected output increases (despite President Trump's best efforts).

US equities advanced in each of the 3 months ending June closing the quarter up +2.9% (S&P 500). Tech stocks broke through the stratosphere and into the mesosphere with the Nasdaq up +7.0%. US 10-year treasuries closed the quarter at 2.86%, as bond prices stabilised.

The major European indices were able to recover some of the losses experienced in Q1 2018. At the index level, UK's FTSE 100 increased +8.2%, Germany's DAX rose +1.7% and the French CAC added +3.0%.

Emerging Asian markets bore the full force of a rising US dollar and the potential fallout from a trade war. Mainland China and Thailand led the declines at -10.1% with Korea falling -4.9%. Hong Kong performed relatively better, losing only -3.8%. Elsewhere in the region, Australia and Japan proved their safe haven status rising by 7.5% (ASX 300) and 4.0% (Nikkei 255) respectively.

Outlook

As we enter the third quarter of 2018 we remain largely optimistic on global markets. Threats of a trade war dominate the headlines and the potential impact it might have on world growth. However, we find this is very similar to the North Korea situation – Trump throws the grenades and then rides in on his horse like a knight in shining armour to save the day. Tough talk on tariffs has almost everyone spooked when really it is only a matter of time before an agreement is reached between Trump and his Chinese counterpart that benefits all parties.

Cutting through the noise we maintain our focus on company fundamentals and identifying quality companies whose growth potential is underpriced. The upcoming US reporting season should confirm that the consumer is still very much in good shape. Record low levels of unemployment together with rising wages are more than offsetting the negative impacts of increasing interest rates and fuel costs.

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Recent strong results from the major US homebuilders highlights the resilience of the domestic economy and specifically that higher borrowing costs are having minimal impact on purchasing decisions.

The US interest rate landscape seems to have calmed down a bit, with the market now expecting a further one to two increases throughout the second half of the year. The combination of rate rises, quant tapering and fiscal spending is potentially not sustainable or feasible. Something will most likely have to give. With quant tapering we enter unchartered waters with unknown consequences and therefore anticipate an extremely slow burn from central bankers.

From a thematic perspective we expect the shift in consumer spending habits towards experiences over things to persist. The portfolio is exposed to this theme through the leading cruise lines and a global hotel operator.

In Europe, Brexit discussions continue to weigh on corporate sentiment and we remain underweight the region.

Reflective of a more constructive positioning for International equities, the Fund’s net equity exposure at the end of June was approximately 95% invested.

Our AUD hedging sits at 10% as rising bond spreads between the US and Australia combined with positive economic news flow out of the US continues to put pressure on the AUD.

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 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 Select and Global Funds have exposure to the oil sector through holdings in BP and Hess.

Hess offers investors access to a world class oil discovery in off-shore Guyana in addition to an industry leading growth position in the Bakken region. Recent non-core asset disposals has focused the portfolio and strengthened the balance sheet. Increasing production momentum with lower costs successfully achieved by management provides a high sensitivity to the oil price.

BP, originally founded by William Knox D’Arcy from Rockhampton, QLD, is a world leading integrated oil and gas company. BP has a solid production growth profile and is delivering on stated strategy commitments with a focus on shareholder value. Currently trading on a FY2019e PE of 13x and offering a dividend yield of over 5%.