

K2 Asset Management

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K2 Australian Fund Monthly Report - 31 January 2017

Australian Market Review

The K2 Australian Absolute Return Fund returned 0.23% for the month of January while the S&P/ASX All Ordinaries Accumulation Index returned -0.77%.

Markets bounced from tweet to tweet throughout January as the world awaited President Trump. With his inauguration complete, Trump wasted little time with the prompt signing of seven executive orders, seven presidential memoranda, and two proclamations. The long lasting impact remains to be seen but there is no questioning his intent. The reflation trade continued to perform well as bond markets struggled, while strong metal prices were helped by continued growth out of China. Confession season saw BXB lower expectations, leaving investors with more questions than answers given their exposure to global growth. Additional downgrades from ACX, SRV, VRT, BAL, VRL, and MEA ensured life remained difficult in the small cap space. The RBA left rates on hold at 1.50%, while the AUD rose 5.0% to USD0.7570.

Healthcare (+4.8%) was the best performing sector helped by strong operational updates from CSL and RMD, while Materials (+4.7%) continued their strong outperformance. REIT's (-4.9%) were the worst performing sector, while Industrials (-4.7%) and Discretionary (-4.3%) struggled as investors questioned domestically exposed earnings.

Portfolio Insight: National Australia Bank

National Australia Bank (NAB) is our largest major bank holding. We have been impressed by NAB's strategy to restructure itself into a bank that is squarely focussed on providing financial services to its Australian and New Zealand customers. Specifically, NAB has committed itself to maintaining and improving its leading position in banking to small and medium sized businesses. We are attracted to this part of the market as we believe that the Australian economy is on the cusp of a sustainable period of improved growth and business lending broadly follows the trajectory of the economy. In fact we believe that business lending growth will most likely outstrip housing over the next few years. In addition, given that business lending is more capital intense than housing, we would anticipate that margins can actually improve. For this reason we share NAB's confidence that it can deliver the best improvement in ROE of all the major domestic banks. In 2015 NAB delivered a ROE of 13.8% whereas peers averaged 16.0%. This year NAB delivered a ROE that was 14.3% and was in-line with that of its peers. We think that in 2017 and 2018 NAB's ROE will be higher than the peer average. Hence we are happy to acquire NAB when it trades on the lowest PE in the sector. NAB is currently trading on a P/E of 12.6x next years earnings. Importantly its dividend yield is 6.5% fully franked. Market expectations are for the dividend to decline over the coming years. We do not share this view.

Outlook

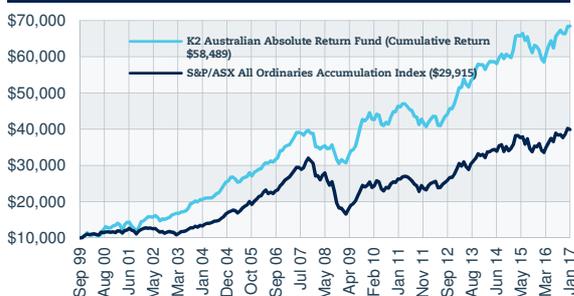
We remain of the view that conditions for investing in Australian equities are favourable. When we compare Australia's top 20 listed companies to those in other developed markets we find that the domestic dividend yield is more than 30% higher than peers, balance sheet leverage is 12% lower and PEs are presently at an 8% discount. Given that global economic activity is broadly recovering, commodity prices are holding up and interest rates are still historically low, we are comfortable running high net exposure. Australia is typically seen as a warrant on global growth. Hence we would expect to see offshore investors increasing their exposure to Australian equities and this should provide support for local share prices. Our main concern is regarding the velocity of movement in 10 year bond yields; if yields rose sharply beyond 3% then we would become more cautious.

Top 5 Stock Contributions - January

Largest	BHP Billiton Limited, Boral Ltd, Cedar Woods Properties Ltd, Medical Developments International, RIO Tinto Ltd
Smallest	ANZ Banking Group, APN News & Media Limited, Henderson Group PLC, Macquarie Group Ltd, Retail Food Group Ltd

Performance to 31 January 2017 (net of fees)	
1 Month	0.23%
3 Months	3.14%
6 Months	4.30%
1 Year	15.27%
3 Years (pa)	6.64%
5 Years (pa)	10.29%
10 Years (pa)	6.79%
Since Inception (pa)	11.74%

Growth of AUD \$10,000



Returns are based on NAV per unit plus distributions reinvested net of management fee and performance fee accruals. The method for calculating the NAV is set out in the Fund's PDS.

Fund Details (Unaudited)

Exit Price Per Unit:	A\$184.57
Distribution 30-Jun-2016:	A\$3.89
Fund Size:	A\$357.7m
Start Date:	1-Oct-99

Top 5 Large Cap Holdings	Sector	%
BHP Billiton Limited	Basic Materials	10.1
RIO Tinto Ltd	Basic Materials	8.3
Macquarie Group Ltd	Financial	6.3
National Australia Bank Ltd	Financial	4.5
Challenger Ltd	Financial	3.8

Sector Exposure %

	Long	Short	Net Equity
Basic Materials	21.7	-	21.7
Communication	4.1	-	4.1
Cons. Cyclical	8.5	-	8.5
Cons. Non-Cyc	10.8	-	10.8
Energy	4.3	-	4.3
Financial	39.3	-0.9	38.4
Industrial	7.2	-	7.2
Technology	0.6	-	0.6
Utilities	0.3	-	0.3
Total Equity	96.7	-0.9	95.8
Total Cash			4.2
Total Equity and Cash Exposure			100.0

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