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K2 Asian Equity Update
Quarterly Report - 30 June 2017

Market Review

The K2 Asian Absolute Return Fund gained 0.6% for the quarter ended 30 June 2017 and 9.9% for the financial year ended 30 June 2017. Since inception in 1999 the Fund has delivered 9.9% p.a..

Recent Chinese economic data points to a continuing expanding economy although at a slower rate than twelve months earlier. Much of this slowdown has been expected as a significant stimulus package from 2016 is no longer in place. Real estate investment rose 7.4% annually in May (vs. 9.8% in April), while infrastructure fixed asset investment grew 12.9% (vs. 22.3% in April). However, China has its improving trends also, with NBS manufacturing PMI 51.7 (vs. April 51.2) and industrial profits growing 16.7% yoy versus April's 14%. China remains a tightly controlled economy with much of the data influenced by government policy.

Oil markets fell over the quarter, down -9.0% to USD46.04 (WTI), placing pressure on oil related names as supply continued to surge from US shale producers.

Significant Asian market events over the quarter included the MSCI inclusion of A-Share (Chinese) listed equities into the MSCI Emerging Market indices. MSCI's decision to include China 'A' shares in their indices will place increased pressure on global managers to increase research efforts into Chinese companies and allocate additional funds to Chinese equities over the next several years.

China's growth is sustainable and a number of factors aid this. The infrastructure needs of relocating 200 million people from rural areas to urban communities by 2025 will spur construction spending and real estate development. Consumer spending remains robust and as disposable income grows purchasing power will continue to increase.

Debt markets which dwarf equity markets are just starting to open up in China. Chinese debt offers yields far above other major economies, with 5% or more available on government bonds with maturities of 5-10 years. As foreign capital comes in, yields are likely to fall with the offset being a rising RMB as currency demand increases. This will provide a boost to consumer spending and the increased liquidity should lead real estate markets higher as rates fall. Why Chinese rates should be any different to US rates is a question to ponder.

The K2 Asian Fund has been the beneficiary of a number of technology related holdings, including Tencent, Sunny Optical, Alibaba and Tongda. These holdings underlie what is a seismic trend in Asia as it continues to develop new industries in sectors around the internet of things. China is the world's largest importer of semiconductor chips and internet circuit boards which they then use as componentry in greater value add products that are exported. In the next few years China aims to become the world's largest manufacturer of IC boards and chips. Chinese purchases of chip fabricating equipment almost tripled from 2006 to 2016, from $2.3 billion to $6.5 billion, as demand increased. The chip sector has seen significant consolidation over the last 5 years and K2 Asian Fund holdings SK Hynix and Broadcom have both benefited from restricted industry supply while demand continues to increase.

Asia as an exporting hub is still highly correlated with the demand economies of Europe and the US. Here the broad economic signs are positive, but maybe not living up to the expectations of optimists.

The political events from the last 12 months are best summed up by Mark Twain when he said "If voting made any difference they wouldn't let us do it." A shock Brexit, followed by Turnbull's close shave, Trump's Tweets, the charismatic Frenchman and most recently UK's hung parliament has demonstrated the market's unwavering resilience...for now.

As we rounded out the quarter central banks globally adopted a more hawkish tone. We especially admire Chairperson Yellen's confidence, proclaiming "we will not have a new financial crisis in our lifetime." This is reminiscent of the Titanic crewman who proudly claimed that "Not even God himself could sink this ship."

Despite mixed political results and the Fed increase of 25bps, the major Asian indices were largely stronger over the quarter. Leading returns was Korea with the KOSPI up 10.7%, driven by larger cap companies including Samsung, the KOSPI's largest constituent which climbed 15.4%. Hong Kong was another market rewarded by investors seeking growth, advancing a further +6.9% as strong corporate earnings underpinned investor confidence. Big brother China was more subdued (-0.9%) despite positive news late in the quarter of impending inclusion in the MSCI global indices. Positive returns for Asia also came from India +3.8%, Singapore +1.6% and the Philippines +7.3%. Australia was the laggard of the bunch, with the ASX 300 declining by -2.4%. Japan increased +6.6% (TOPIX) as the Yen fell by a modest -0.9% vs the USD. The AUD closed June at USD0.7689, up +0.8% for the quarter.

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Outlook

Asian equity markets are currently enjoying an extended period of excessively low volatility and our long term view remains positive. In the short term we harbour growing concerns that investors have become a bit too complacent and whether this might be the calm before the storm as markets have extended gains and valuations have become less attractive.

Valuations are like an elastic band, once they reach a point of maximum stretch they either break or more than likely snap back. In a low interest rate environment, where returns are scarce, justification exists for chasing growth at any price. However, recent hawkish rhetoric from central banks makes it clear that US rates are rising and sooner rather than later. This will put further pressure on already stretched valuations as discount rates rise.

On the flip side, financials are a significant beneficiary of rising rates and when combined with buyback support and increased dividends we are comfortable increasing our exposure to that part of the market. Fund holdings of DBS Bank in Singapore and HSBC are a beneficiary of high US rates as it sources funding from overseas.

The Fund progressively reduced net exposure during the June quarter. Long exposure was reduced from 85.3% in March 2017 to 55.0%. In addition the Fund's short exposure rose from 1.0% in March 2017 to 1.5%. Accordingly, the Fund's net exposure is 53.5%; 30.8% lower than 3 months ago.

Portfolio Insight: SK Hynix

Korean semiconductor manufacturer, SK Hynix, has experienced many cycles in an industry wracked by excess capacity chasing higher prices when available. But things have changed. Industry wide consolidation has removed many of the marginal manufacturers reducing much of the excess supply. This has left SK Hynix and other mature semiconductor companies to benefit from growing demand and rising pricing (with tight industry supply) driven by increased chip proliferation in products ranging from smartphones to increased technology in the automotive industry. With DRAM (dynamic Random Access Memory) pricing up +90% over the last 12 months, much of the revenue uplift is yet to be reflected in company earnings, suggesting estimates will need to increase further. SK Hynix shares trade on 1.1x book value and a forward P/E of 7x.