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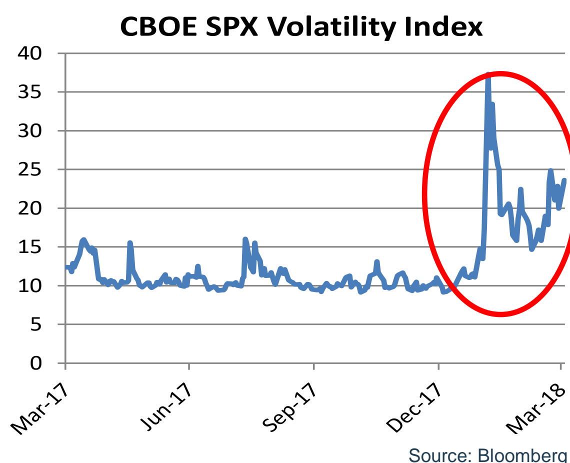
K2 International Equity Update
Quarterly Report - 31 March 2018

Market Review

The K2 Select International Absolute Return Fund returned -0.88% for the quarter ended 31 March 2018.

According to Agatha Christie the best way to kick start your imagination is to eat apples in the bath. Personally I prefer oranges but either way even one of the world's most gifted authors would have struggled to dream about some of the events from the last three months.

Euphoria reigned through January with global stock markets pushing higher as domestic and international investors bought into the synchronised global growth story fuelled by US tax cuts. The Chinese and Hong Kong markets in particular were a significant beneficiary of the hubris with Hong Kong rising 9.9% in January alone. This confidence came to an abrupt end through February with markets giving up most and in many cases more than the gains earned in January. Market participants who were invested in low volatility products, such as the XIV US (A fund set up to provide positive returns betting on continued falling volatility in the US S&P 500 Index) blew up in a spectacular way. As the S&P 500 tumbled -4.1% on 5 February, volatility spiked to 37% resulting in the XIV ETF alone falling more than 96% before it had its trading suspended and then the fund liquidated. This liquidation cost holders billions of dollars and is a great example of how investors need to understand the inherent risks attributed to any perceived passive investment that they hold.



Source: Bloomberg

Much of the euphoria that was drained from markets in February started with President Trump's announced tariff policies that are aimed at protecting US Steel and Aluminium interests. Global trade was called into question, tariff wars may re-ignite and markets generally had a wobble. Slowly more information came to light with various countries being exempt from the tariffs including Canada, Mexico and Australia. We suspect long term, this list will only grow. The main Nation that doesn't receive an exemption will be China, who not to be outdone, quickly retaliated with proposed tariffs on a list of 128 US products ranging from wine to pork. However, based on what has been announced so far, our analysis suggests these will only have a minimal impact on both countries' GDP if things do not escalate further.

Frosty tensions between Russia and the UK deteriorated over the poisoning of a former Russian spy and his daughter in England with the spill over reverberating around the Western world. In isolation, this might not be significant for markets, but when thrown into the mix of an already tense geo-political climate it only adds fuel to the fire. In the meantime, while Russia flatly denies allegations of its involvement in the poisoning, 59 diplomats from 23 other countries have been expelled from Moscow for backing the UK.

Post the initial sell-off in early February, markets began to stabilise and slowly move higher but volatility has remained with markets gyrating to daily news flow, especially from the Trump administration. That said, not all the news flow has been because of President Trump. Chinese President Xi Jinping created three significant headlines; firstly the consolidation of power that has now made Xi Jinping the most powerful leader of China since Mao. Secondly, the proposal from China's governing Communist Party to remove a clause in the constitution which limits presidencies to two five-year terms effectively enabling Xi Jinping to rule for life and thirdly, Xi Jinping released the new Chinese growth targets for 2018 with a GDP target of "around 6.5%". The word "around" has been met with mixed enthusiasm from market participants and is seen as a possible watering down of growth expectations for the Chinese economy. That said, it has been seen that Xi Jinping cannot control everything as January and February economic activity picked up as trade and FAI figures were both better than expected. This has resulted in a number of economists upgrading their forecasts for fiscal Chinese GDP to near 6.8%.

We have written previously about the North Korean crises and the fact that we had undertaken numerous meetings with Korean and US officials in attempting to get a better and more informed perspective on the Korean Peninsula crisis. Our base case was always that war would be averted as the threat of mutual destruction (North & South Korea) was totally unpalatable. It seems that sport, more precisely, the Winter Olympics may end up being the bridge that can bring these two nations closer and we marvelled at how far winter athletes will push themselves in the pursuit of glory. However the real story, if successful, may be that PyeongChang became the first staging point for a more harmonious relationship between Pyeongyang and Seoul. With Government Officials from both sides meeting at Panmunjom, and in a move (that we hope will be positive) President Trump agreed to meet Kim Jong-un, we seem closer than ever to ending a state of war that has existed between the two Korea's since the Korean War started in 1950. It has also been reported that Kim Jong-un has made a trip by train to China to meet with President Xi Jinping. These are interesting times we live in.

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We met with a number of interesting companies over the last 3 months. Ranging from German REITs who are seeing increased occupancy rates and rising rents to Canadian Uranium miners who are shutting facilities on the back of ongoing soft spot prices. A more unique meeting was held with management of Investors Cloud Ltd, a growing Japanese property development and internet advertising company. In addition to providing a matching, construction and management service for selling land holders and potential unit investors, the company is establishing an online real estate advertising platform. Expectations of 30% market share within two years are sky high but so is their potential to disrupt existing established players by offering a cost per click structure and undercutting competitors on price. Watch this space. Currently trading on a FY19 expected PE of approximately 29x we feel that most of the potential upside is already in the price despite a significant amount of execution risk and will patiently wait for a more attractive entry point.

Oil increased a further +7.5% (WTI) as US stockpiles continue to decline with OPEC and friends honouring their agreed production cuts. Despite a strong start, US equities ended the quarter down -1.2% (S&P 500). Tech stocks hit severe turbulence throughout February and March but still managed to end the quarter in positive territory with the Nasdaq up +2.9%. US 10-year treasuries closed the quarter at 2.7%, as bond prices fell with news of tax cuts, quantitative tightening and increased government spending expected to put further pressure on an already ballooning budget deficit.

The major European indices fared significantly worse than their counterparts across the pond. At the index level, UK's FTSE 100 fell -8.2%, Germany's DAX declined -6.4% and the French CAC dropped -2.7%.

Asian markets were mixed in Q1 but this belies the volatility within. Following strong performances in 2017, Hong Kong eked a further +0.6% gain. Big brother China wasn't as fortunate, falling -4.2%. Korea fell -0.9% while Australia, down -5.0% as defined by the ASX 300, gave up most of the gains from Q4. Japan declined -5.6% (TOPIX) with the Yen strengthening by 6.0% vs the USD as a corruption scandal involving Prime Minister Abe's wife threatens his position, and by association, the potential end of Abenomics. The AUD closed March at 76.79 US cents, down -1.7% for the quarter.

Outlook

As investors we consistently ensure that we are asking ourselves questions and testing our hypothesis on stocks and markets. One of the questions that we are currently asking ourselves is about "Synchronised Global Growth"; will it be as strong as we thought? Markets tend to price in the rate of change of growth, and as rhetoric increases around tariffs and trade wars, it is possible that the global growth may end up slower than markets expected back in December. Markets despise uncertainty and uncertainty leads to volatility as investors digest new information. It is with this in mind that the portfolio has taken a more defensive stance with cash and short positions now representing more than 15% of the portfolio.

In December, we wrote about our cautious optimism and in many ways this still remains as corporate earnings are strong, as highlighted by the Q1 US reporting season. Equities remain the best way to participate in global growth; however equities have always been seen as a "risk" asset and as such will always be vulnerable to the emotive reactions of investors. Within the K2 DNA, we have a keen focus on capital protection with a belief that if you can protect from significant market falls, the ability to compound returns off that higher base leads to a better through-the-cycle outcome for all investors. Thus until we get greater clarity on the economic landscape, the Fund will look to maintain its more defensive pose.

Moving through 2018, the US interest rate landscape seems to be changing daily, with the market seeming to settle on three 25 basis point increases during the year. With quant tapering we enter unchartered waters and therefore anticipate an extremely slow burn from central bankers to avoid any unintended consequences, but risks remain.

Reflective of a more defensive positioning for International equities, the Fund's net equity exposure at the end of March was 76% invested. In addition, short portfolio positions currently total 3.7% as we seek alpha opportunities in structurally challenged names with little valuation support. Our AUD hedging sits at approximately 25% as positive economic news flow out of Australia and the US is offset by inflammatory rhetoric that has increased volatility.

Portfolio Insight: Broadcom Ltd - K2 Select Absolute Return Fund

Broadcom, until recently domiciled in Singapore, is a leading global manufacturer and supplier of semiconductors and wireless related components. A targeted focus towards structural growth areas including enterprise storage (the cloud) and Radio Frequency (RF) wireless communications, the company has delivered above industry growth rates. In the short-term, content growth within end user applications (i.e. smartphones) is driving demand for Broadcom's RF wireless products while the explosion in cloud based storage provides a solid foundation for the longer-term.

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Broadcom is a proven consolidator with the semiconductor industry and led by CEO Hock E Tan, the company launched an ambitious USD100bn+ bid for Qualcomm in November 2017. Funding from a consortium of banks was arranged in what would have been the largest ever debt facility if completed. A war of words quickly erupted between the respective management teams with the final word belonging to President Trump who not wanting to be outshone abruptly declared on 12 March via Presidential Order that the proposed takeover was “prohibited” on national security concerns. We all know that you can’t fight city hall and with that the offer was withdrawn.

While the acquisition of Qualcomm would have been significantly earnings accretive, the enormous levels of debt along with a complex integration process would have meaningfully increased the overall risk profile of the company. As long-term shareholders we do sleep better at night under the current structure where management can focus on maximising shareholder returns from the existing asset base without having to place additional stress on the balance sheet. While we acknowledge the company’s successful history of acquisitions this one might have been like trying to reel in an Atlantic Bluefin tuna from a dinghy.

Pleasingly however, Broadcom continues to fire on all cylinders. The company’s FY18 Q1 results showed a further strengthening of the business case as evidenced by ongoing margin expansion. Without the noise of large scale corporate activity from the Toshiba memory and Qualcomm bids that has plagued the share price, there is now clean air ahead for investors. Free cash flow is forecast to be greater than USD8bn p.a. in 2018 and rising to USD10bn by 2020 paving the way for large share buybacks. Trading on an un-demanding 2018 PE of 12.5x and supported by +20% FY18 EPS growth the company is well positioned for multiple expansion.