

K2 Asset Management

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K2 Australian Fund Monthly Report - 30 September

Australian Market Review

The K2 Australia Absolute Return Fund returned -4.76% for the month of September while the All Ordinaries Accumulation Index returned -6.27%.

Investor focus during September was once again centered on Europe and the numerous possible solutions being proposed to resolve the financial crisis facing the region. Macro data which continues to deteriorate suggests an increasing likelihood of a recession in Europe during 2012. In the course of the month the US Fed announced "operation twist" in a bid to further help lower funding costs for corporate & households alike; although this announcement failed to excite the market and provide any catalyst for stabilisation. Commodity prices fell sharply, particularly gold & base metals, on concerns the Euro recession would impact on emerging markets, particularly China.

Economic data for Australia continued to highlight the softness in the non-mining sectors of the economy. House prices, retail sales, credit data remained weak while employment & building approvals continued to decline. The RBA remained on hold at 4.75%, however finally acknowledged the global economy is faltering and the European debt crisis could have a negative impact on the domestic economy. Currently interest rate markets are pricing in 150bps of rate cuts by June 2012.

Domestic investors continued to reduce exposure to cyclical sectors in favour of defensive sectors; Materials (-13.56%), Energy(-7.94%), Industrials(-6.53%) being the worst performing sectors; Telcos (+2.6%), Staples(+1.2%) & Healthcare(-2.39%) were the best performing sectors.

Outlook

Now that the Australian 10 year bond is yielding close to 4% we are surprised that the standard variable home loan rate is still at 7.8%. Given that lending in Australia has all but stopped and that term deposit rates have now fallen, we feel that the major banks need to return some of the excessive funding margin that they subjected borrowers to during the Global Financial Crisis (GFC). Australian banks were given a lot of latitude during the GFC; regulators allowed two significant mergers, shareholders subscribed to highly dilutive equity raisings and the government guaranteed deposits. It is now time for Australian banks to do some of the heavy lifting and ensure that Australian households are no longer subjected to unnecessary financial stress.

Unfortunately the major banks are clinging to unrealistic economic forecasts. They seem to believe that Australia's unemployment rate will fall below 5% over the coming year, the CPI will average 3% for 2012 and the cash rate will rise to 5.0%. We are more concerned that lead indicators are pointing towards a sharp decline in Australia's terms of trade; namely IMF's recent cut to its global growth forecast, the 25% drop in copper prices and the 9% decline in the A\$ last month. We feel that the Reserve Bank of Australia (RBA) must moderate its hawkish stance and indicate that the next move in rates will be down. This change in tact is required since Australian bankers are unlikely to compete with one another until the economic path is paved for them.

Our net exposure has dropped below our long run average of 65%. Although we are confident that valuations are compelling, we are concerned that equity investors globally are losing faith in the direction of fiscal and monetary policy.

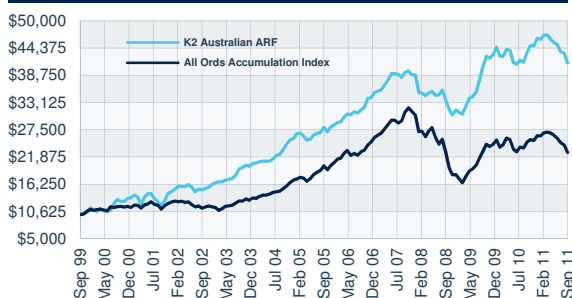
Portfolio Realised Gains & Losses - September

Long Sales	Australia	Profits	CSL Ltd, Dexus Property Group, Perseus Mining Ltd, Telstra Corp Ltd
Long Sales	Australia	Losses	AMP Ltd, Aust and NZ Banking Group, BHP Billiton Ltd, Fortescue Metals Group Ltd, Incitec Pivot Ltd, Insurance Australia Group, JB Hi-Fi Ltd, National Australia Bank Ltd, Qantas Airways Ltd, RIO Tinto Ltd, Stockland, Tabcorp Holdings Ltd, Vocus Communications Ltd, Westpac Banking Corp
Short Covers	Australia	Profits	AGL Energy Ltd, Newcrest Mining Ltd

Performance to 30 September 2011 (net of fees)	
1 Month	-4.76%
3 Months	-8.55%
6 Months	-12.24%
1 Year	-4.87%
3 Years (pa)	7.07%
5 Years (pa)	5.13%
10 Years (pa)	13.24%
Since Inception (pa)	12.54%

The Fund's aim is to generate a 15%+ per annum return, net of fees and expenses, over an investment cycle.

Growth of AUD \$10,000



Returns are based on NAV per unit plus distributions reinvested net of management fee and performance fee accruals.

Fund Details (Unaudited)

Net Asset Value Per Unit:	A\$160.86
Distribution 30-Jun-2011:	A\$3.62
Start Date:	1-Oct-99
S&P Fund Rating:	★★★★★

Top 5 Large Cap Holdings	Sector	%
AMP Ltd	Financial	7.5
Commonwealth Bank Of Australia	Financial	6.0
National Australia Bank Ltd	Financial	5.6
Telstra Corp Ltd	Communication	5.4
Woolworths Ltd	Cons. Non-Cyc	4.6

Sector Exposure %

	Long	Short	Net Equity
Basic Materials	8.9	-	8.9
Communication	7.5	-	7.5
Cons. Cyclical	11.6	-4.9	6.7
Cons. Non-Cyc	8.0	-4.6	3.4
Diversified	-	-	-
Energy	1.9	-	1.9
Financial	30.6	-5.4	25.2
Funds	-	-	-
Industrial	7.9	-	7.9
Technology	-	-	-
Utilities	-	-	-
Total Equity	76.4	-14.9	61.5
Total Cash			38.5
Total Equity and Cash Exposure			100.0

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