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K2 Asian Equity Update
Quarterly Report - 31 December 2017

Market Review

The K2 Asian Absolute Return Fund gained 4.3% for the quarter ended December 2017.

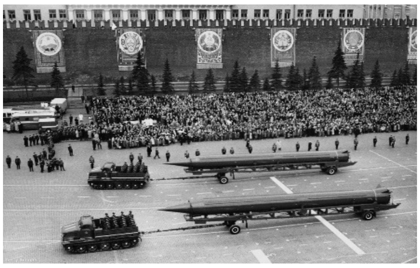
Global equity markets continued to surge higher over the last 3 months spurred on by the promise of US tax reform finally passing through both houses of parliament. After an extended game of political ping pong there is now light at the end of the tunnel. While full details are yet to be announced as we go to print the final storyline could still play out like a good John Grisham thriller with a few more twists in the tail. Asian markets have embraced the positive tone of tax reforms and remain a levered play on synchronised global growth.

Asian markets swung from gains to losses through the final quarter of 2017 as markets succumbed to sector rotation in December (investors selling areas that have performed well to lock in profits) and thus sector and country returns diverged markedly. This sector rotation drove the Shanghai Chinese market to post a negative return for the Quarter, falling by 1.3%, while the more mature Hong Kong market rose 8.6% and stronger than expected earnings pushed the Hang Send Index higher. The Hong Kong market had stellar year with the Hang Seng returning over 36% while Shanghai was far more muted, delivering only 6.6%. Entering 2018, the Chinese market trades on a low valuation multiple and may offer more opportunities through 2019.

The large northern Asian markets of Korea and Taiwan both had years to remember. Korea, one of the cheapest markets globally rose 22% over the year and finished off with a 3.1% gain in the final quarter; much of Korea's performance was driven by its largest company, Samsung Electronics which rose 41.4% through the year spurred on by record sales of smartphones and semiconductor chips. Korea was not a one-way trade, as much of its heavy industrial industries struggled in the face of rising competition and over supply. The Korean shipbuilding industry saw multiple setbacks while its automotive sector struggled as rising competition from Chinese auto manufacturers and electric vehicles took its toll. Technology heavy Taiwan showed a more muted gain as the Taiex Index rose 15% in 2017 and 3.0% in the final quarter. In a year when the technology sector led gains, Taiwan is in relative terms a disappointment. The Taiwan equity market is tech heavy, but suffers from being a supply chain manufacturer (a price taker rather than price setter), and with increasing competition many of its companies where left behind in the global tech race.

The Asian markets (Indonesia, Philippines, Singapore, Malaysia, Thailand) are significant beneficiaries of global trade, but also represent sustainable growing economies in their own right. Classified by MSCI as a developed market, the Singaporean economy came out of the doldrums and posted significant GDP improvement as its main drivers of economic growth (banking, trade and housing) all improved. The Singapore Straits Times Index rose 18.1% for 2017 and 5.7% in the December quarter. One of the Fund's largest holdings, Singaporean bank DBS Group Holdings rose 19.3% in the final quarter as investors started to realise its growth potential and multiple ways the bank can succeed. The developing stock markets of the Asian region all had positive years. The most significant gains were reserved for the Philippines rising 25.1% for the 12 months and 4.7% for the quarter, while resource heavy Indonesia wasn't far behind with 20% for the year and 7.7% for the quarter.

A number of "Geo-political" risks raised their ugly heads through 2017 and although the spectre of these may have only diminished temporarily, markets remained sanguine about the possibility of any fallout. In reference to North Korea, we took some solace in Eric Schlosser's book, "Command and Control", a fascinating insight into the history of nuclear weapons in the US and globally. Schlosser takes us back to the great arms race between America and the Soviet Union in the 1950's and early 60's. Broadly speaking, the general consensus from military and political leaders was that the real power of nuclear weaponry was in possessing them and making sure that your opponents are aware you have them, NOT actually using them. History is always an insight into the future, however information is power and during the quarter we had meetings with experts in this field including Stephen Hadley (21st US National Security Advisor) and Max Baucus (The US Ambassador to China 2014 – 2017).


Soviet Union show of military strength in Red Square in 1961

K2's fund managers spent time in Asia through the final quarter of the year meeting with numerous companies from various sectors, including technology, property, insurance, banking and the consumer sectors. The stand out meetings from these trips came from the Chinese auto sector, with companies such as Geely Automobile Holdings and Guangzhou Automodile Group performing strongly and the finance sector where Singaporean banking giant DBS is rolling out a fin-tech platform that is second to none in Asia. Chinese Insurance was the other shining light, with Ping-An Insurance especially interesting as they move to a more technology oriented platform that will see them improve distribution and lower costs.

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When dealing with many and diverse economies, one of our core strengths is understanding and interpreting the economic and political factors that shape the region. Insights into the direction of the Chinese economy by Prof. Jun Fu (Executive Dean of the School of Government, Peking University) shed light on policy and the hurdles that the Government still want to clear, while time spent with Prof. Minxin Pei (Professor of Government at Claremont Mckenna College) and Prof. Dr. Bo Chen, (Executive Director of the Research Inst at Huazhong University of Science & Technology) reviewing China's 19th Party Congress and the power that President Xi Jinping now exerts over the future direction of Chinese policy was invaluable. Going forward in these quarterly reviews, readers will see more and more time spent on "One belt, one road", the Chinese infrastructure plans that will help cement China at the crossroads of global trade.

Oil increased a further +16.9% in the quarter boosted by pipeline disruptions and shrinking stock piles. OPEC met at the end of November, agreeing unanimously to extend production cuts through until the end of 2018. The Fund has oil exposure through Thailand PTT Plc, a diversified oil company with upstream and downstream investments. The AUD closed December at USD0.781, down –0.3% for the quarter.

Outlook

As we draw the curtains on 2017 we take comfort in the belief that the world might actually be in better place than expected this time last year. Synchronised global growth is the rising tide lifting all boats supported by a continuation of accommodative monetary policy in all major regions. Unemployment rates remain at multi year lows and bad debts across the banking industry are almost negligible. Throw in a global tax cut war and the prospect of increased fiscal spending and we have the recipe for a robust setup into 2018.

However, as prudent fund managers we focus on company fundamentals and are constantly stress testing our assumptions. We harbour growing concerns that the market tolerance for risk is becoming a bit too complacent, ranging from the sharp rise in unregulated consumer credit to Bitcoin. The VIX index, a measure of 30-day implied S&P 500 Index option volatility, remains at record lows of approximately 10%.

Putting all this together our disposition has improved to that of cautious optimism as we gain comfort from the markets ability to successfully navigate any short-term disruptions and march on to successive new highs.

Moving into 2018, greater uncertainty surrounds the US interest rate landscape with the market expecting anywhere from one to three 25 basis point increases over the next 12 months. With quant tapering we enter unchartered waters and therefore anticipate an extremely slow burn from central bankers to avoid any unintended consequences. The lower for longer interest rate environment has continued to provide valuation support for the market helped by solid earnings growth.

Asia is a levered play on this synchronised global growth and with economic growth rates being revised upwards, Asia remains one of the most attractive places to invest. Our view is premised on the fact that Asia has a number of tailwinds that may allow it to outperform other equity markets. Domestic orientated growth driven by an ever growing middle class with discretionary income and climbing spending power, valuations that are cheaper than the US and Europe and the region being the greatest beneficiary from global growth and the subsequent pick up in global trade.

Reflective of a more optimistic outlook for Asian equities, the Fund's net equity exposure at the end of December was approximately 92% invested. In addition, short portfolio positions currently total 2.2% as we seek alpha opportunities in structurally challenged names with little valuation support. We have decreased our AUD hedging to zero to reflect our negative stance on Australia and the Australian Dollar relative to the rest of the world.

Portfolio Insight: DBS Holdings Group Ltd

DBS CEO Piyush Gupta

With improving global economic growth and a yield curve that can only steepen from its current flat structure, we believe banks have significant tailwinds to appreciate over the next 12 to 24 months.

However some banks are more equal than others. One such bank that we believe shows a clean pair of heals to its competitors is DBS, a leading south-east Asian banking franchise based out of Singapore. What really excites us about DBS is its global best in class technology platform which is considered the regional leader in its rollout of digital capabilities. In carrying out our channel checks, we met with ING, the Dutch bank, who is considered by many as having the best technology / Fintech platform of any bank globally. In ING's own words, the only bank whose technology platform compares to ING is DBS and they are the clear leader in Asia.

DBS will benefit from rising global interest rates and a steepening yield curve in 2018 which should see net interest margins expand. Current focus on growing the wealth management division will increase recurring revenues thus providing a more stable income that requires less balance sheet capital. Trading on an undemanding forecast FY18 expected PER of 11.5x with forecast EPS growth of 18.7% p.a. over the next 2 years, DBS represents a significant position in the Fund.