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K2 Australian Equity Update
Quarterly Report - 31 March 2017

Market Review

Volatility remained suppressed at an index level throughout 1Q17, yet beneath this sector rotation and political noise were significant. With Trump's inauguration complete, the global reflation trade began to wobble and defensive sectors outperformed. The Atlanta Fed's 1Q US GDPNow forecast was walked down from 3.4% on 1 February to 0.9% as at 31 March. Slower near-term GDP, a Fed rate rise in March, and a lack of cohesion in the Republican party has seen growth expectations tempered. While investors remain hopeful tax reform receives a safe passage in Washington, the failed repeal of Obamacare ensures a bumpy ride ahead. According to Morgan Stanley, Australian earnings season saw 45% of companies beat estimates and 33% miss. Earnings momentum will continue short-term with Resources remaining cum-upgrade on a mark-to-market basis, yet we continue to watch oil and iron ore stockpiles which have crept to all-time highs. The RBA remained on hold throughout the quarter, while the AUD rose 5.8% to USD0.763.

Healthcare (+14.0%) was the best performing sector, with Utilities (+9.6%) and Staples (+8.8%) completing the defensive trifecta. Weakness was seen in the Telco sector (-7.5%) as NBN uncertainties and poor earnings saw sector wide selling, while REITs (-1.1%) and Materials (+0.1%) also underperformed the broader market.

Outlook

Most major equity markets experienced their post GFC lows in March 2009 and have subsequently rallied consistently for the past 8 years; the All Ordinaries Accumulation Index has risen over 150% whereas the total return for the S&P500 is up over 280%. In addition, the All Ordinaries Accumulation and the S&P500 Total Return indices have surpassed their pre-GFC highs by 32% and 86% respectively. Given the longevity of the current recovery we feel it is prudent to gauge equity market valuations.

The median PE ratio of Australia's largest companies is approaching 17x next year's expected earnings. Over the past 30 years the only times that a PE of 17x has been surpassed for more than 3 consecutive months was in 1999 and 2007. On both occasions the PE gradually declined to 15x over the subsequent 12 months. Importantly, the PE de-rate was driven by improving profits not falling share prices. We feel this will be repeated again over the coming year and hence we are looking to invest in companies with highly probable growth avenues.

The K2 Australian Fund continues to run an overweight position in Australia's leading resource companies. We believe that global conditions will continue to support commodity prices throughout 2017 and hence resource company profits still have meaningful upside. Since early last year the major global resource companies have resisted their normal tendency to respond to higher commodity prices with a surge of supply and capital expenditure. This new found discipline has resulted in a significant improvement in shareholder returns and gearing levels. We feel that more is in store and that most sell side analysts are still behind the curve.

It is our expectation that opportunities to short sell will become increasingly prospective over the coming 12 months. The K2 Australian Fund has deliberately avoided short selling for the past 4 years on valuation considerations; since 2012 we judged that equities were the most attractively priced asset class. However we feel that the majority of this valuation arbitrage has played out. We are not bearish. We just feel that some equity prices are starting to out stretch their earnings potential. Typically at this point in the cycle high growth companies are priced exuberantly. As a result, small operational hiccups can subsequently have a dramatic effect on share prices. We have begun to short sell a few of these perfectly priced business models on the expectation that operational excellence is not always assured.

We are noticing that an inflation backlog is beginning to build within the Australian economy. There is little doubt that declining eastern state gas production will force gas-powered electricity generators to lift prices. In fact the CPI for Australian gas and other household fuels has already risen 1.9% over the past 12 months and this has in-turn driven electricity prices 4.7% higher. In addition, the average unleaded petrol price for the March 2017 quarter is nearly 15% higher than last year. At the same time property prices have again strengthened this calendar year which will have additional inflationary implications. We are also mindful that Cyclone Debbie could fracture the logistics network in the northern states and domestic fresh food prices may be abnormally stronger in the June quarter. So all up we feel that inflation expectations will start drifting higher and domestic interest rates will most likely follow. Since the end of 2016 we have gradually reduced our net equity exposure by nearly 10% and it is currently sitting at 86%.

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Portfolio Insight: Suncorp Group - K2 Australian Fund

Suncorp is one of the largest general insurers in Australia and New Zealand. The group also operates banking, life insurance and wealth management operations throughout Australia with a geographical bias to Queensland, with $97 billion of assets and 13,500 employees servicing 9 million customers. Suncorp is one of our largest holdings. We believe that Suncorp has the potential to significantly improve the magnitude of the returns that it delivers to shareholders and that its 13.8x PE multiple is attractive relative to peers such as IAG at 16.4x and the major banks at 14.1x.

Michael Cameron took on the CEO role at Suncorp 16 months ago. His appointment followed 5 years of an average return on shareholders' equity (ROE) of just 6.5%. We believe that Michael's prior experience at Commonwealth Bank and GPT Group ensures that he is well equipped to deliver on his stated goal of driving Suncorp's ROE beyond 10%.

We believe that the most logical starting point for Suncorp is to assess the merits of maintaining a presence in life insurance. Suncorp's life insurance business carries $8.2 billion of assets and is supported by over $2 billion shareholders equity. The return on the life assets has fallen 30% since 2009 and the ROE is now below 6%. We would have thought that it is very hard for Suncorp to compete in the life insurance space. Competitors seem to have a significantly lower cost of capital and are increasingly becoming specialised players. The benefits of selling the life insurance business are two fold; firstly group ROE would gravitate higher and importantly company resources could be re-directed to market segments where Suncorp has a position of strength. By way of example, Suncorp controls more than 30% of the market for motor and home insurance in QLD, NSW and Victoria. Yet Suncorp's retail banking operations have just 8.8%, 0.8% and 0.4% of the respective QLD, NSW and Victorian markets. We believe Michael Cameron is determined to improve the performance of the banking franchise. If Suncorp can leverage off its general insurance expertise and improve the pricing of its retail loans then the ROE of the banking operations could improve to well over 10%.

Near term it is likely that market participants will be wary about the financial impact from Cyclone Debbie. However it should be noted that Suncorp has significant reinsurance cover in place. At face value it would appear that Cyclone Debbie will have very limited impact on Suncorp's capacity to pay dividends this year. We believe that Suncorp is attractively priced and offers a 6.0% fully franked yield on next years' dividend. This compares favourably to the 4.9% average yield offered by the major banks and other general insurers.

Portfolio Insight: Updater Inc. - K2 Small Cap Fund

Updater Inc. is a US based technology company that takes the stress out of moving house. From finding a reputable moving company to connecting utilities and digital services, Updater's unique platform streamlines the administrative headache of relocating, offering a plethora of services to the mover via a user friendly online portal.

Total moves processed (market share) and monetisation of the service offerings are the two key value drivers for Updater. The company's latest data shows a 7% share of all moves processed with the company guiding to a target of 15% by the calendar year end. Monetizing the service vertical is in pilot testing phase with USA's second largest Property & Casualty Insurer, Liberty Mutual, undertaking the program. The company is expected to announce a further 2 pilot programs, from other verticals, this year.

During the month, Updater released initial results for the pilot program which far exceeded their own and market expectations. The testing showed that, with over 95% confidence, pre-movers exposed to Updater communications are more likely to purchase applicable insurance products. In fact, those pre-movers purchased insurance products at a 93% higher rate. This is a significant step towards monetizing the platform and with tailored enhancements made to the offering, results will improve further.

Updater is a key holding for the K2 Australian Small Cap Fund. We are buoyed by the future prospects for the company and we will continue to closely monitor the company's developments. Material upside for shareholders exists as the company can successfully execute their strategy going forward.