Ironbark Karara Australian Share Fund

Monthly Investment Report as at 31 January 2019

Asset class

Australian Equities

Investment objective

To outperform the benchmark (before fees) over rolling 4 year periods

APIR code

PAT0001AU

ARSN

114 291 299

Fund inception date

30 June 2005

Manager appointed

1 May 2010

Benchmark

S&P/ASX 300 Accumulation Index[1]

Distribution frequency

Semi-annually

Minimum investment

$20,000

Fund size

$48.4m

Exit price

$1.5335

Market review

Global markets rebounded broadly through January (S&P 500 up 7.8%, Stoxx 600 up 6.2%, and MSCI World Index up 7.2%) because policy makers displayed some urgency to address the root causes of the December quarter's steep declines. Firstly, the US Federal Reserve abruptly dis-engaged from its tightening strategy. Secondly, China stepped up fiscal and monetary measures to stem slower growth. Finally, the likelihood of a trade agreement between the US and China improved as both sides demonstrated intent to reach compromise.

The Australian market had a harder time expressing the sharp U-turn in global sentiment and policy outlook, however, the S&P/ASX 300 Accumulation Index still managed a 3.87% gain. Beyond strong performance in some international cyclical sectors, namely mining and energy, select small cap tech and China plays, the heavy lifting was generally provided by mature, defensive sectors. REIT's had their best month in over 2 years rising 6%, and extending outperformance over three months to 8.5%. Telecommunication's added 8.5%, and utilities were up 6.0%. Although the telecommunications sector outlook was improved by TPG's decision to abandon its mobile network rollout, all benefitted from the desire of investors to re-enter the market yet anxiety remained about exactly where togo.

Banks and wealth managers fell pending the release of the Hayne Royal Commission's final report. Domestically oriented businesses struggled under the shadow cast by (and headlines pertaining to) 'collapsing' stock markets and local house prices, the responsible lending induced bank 'credit crunch', and global trade wars, all of which seemingly took a toll on consumer and business confidence and activity in December. The broad de-rating of anything potentially exposed to these factors continued. This was amplified, as common in January, by a negative disclosure bias from companies forced to disclose poor results while the remainder, that have been acceptable, wait for February to release results. Warnings from Costa, Kathmandu, Wesfarmers' K-mart, and Air New Zealand fed a market narrative of weak Christmas trading. Better trading numbers from Sky City, Baby Bunting and Target, were interpreted as outliers.

As falling Australian yields and the widening discount to the US long bond rate illustrates (Australian 10 year yields fell 0.09 to 2.23%), the market is firmly at odds with the Rerserve Bank of Australia's base case of approximately 3% gross domestic product growth, 2% inflation and a declining unemployment rate. Cash rate expectations continued to decline with one rate cut now priced by year end. At month end, the Rerserve Bank ticked down its growth expectations and hinted at less conviction in its tightening bias.

Performance review

The Ironbark Karara Australian Share Fund (the 'Fund') returned 3.39% (net) for the month, underperforming the benchmark's return of 3.87% by 0.48%.

Positive gains came from energy, mining and small gold holdings leveraged to commodity prices. Santos (up 18%), Origin (up 11%), Rio Tinto (up 11%), and Saracen (up 15%) were stand out performers for the month. BHP managed to rise another 6% on top off-market buyback enhanced December returns leading the Fund to trim its overweight position.

Performance

Net returns (%)	1 month	3 month	1 year	3 years p.a.	5 years p.a.	7 years p.a.	10 years p.a.	Since inception p.a.[2,3]
Fund Returns	3.39	-0.11	-2.55	9.12	4.53	8.10	8.74	6.07
Benchmark Return[1]	3.87	1.38	1.08	10.04	7.05	9.26	10.08	6.92
Active return	-0.48	-1.49	-3.63	-0.92	-2.52	-1.16	-1.34	-0.85

Past performance is not an indicator of future performance. Net performance figures are calculated using exit prices, net of fees and reflect the annual reinvestment of distribution. Returns are rounded to two decimal places. Slight variations to actual calculations may occur.

[1] The S&P/ASX 300 Accumulation Index was adopted as the Fund's performance benchmark on 1 July 2010. Benchmark calculations prior to this date are based on the S&P/ASX All Ordinaries Index.

[2] Karara Capital appointed investment manager on 1 May 2010, Fund performance prior to this date is not attributable to Karara Capital but the prior manager.

[3] This figure represents the annualised performance of the Fund since inception.

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Performance review (continued)

The tragic Vale dam collapse late in the month showed starkly (again) the ethical, social, and governance risks implicit in mining. Two major disasters in less than three years (as well as the forced shut-in of the Alunorte alumina refinery) will force significant changes to the Brazilian iron ore industry that will reduce volumes and increase unit cost for the foreseeable future. This likely removes the expected surplus of iron ore in 2019 with higher prices needed to encourage production from more marginal producers such as Fortescue (up 35%).

Stock selection in financials also contributed nicely with the largest underweight holding, the Commonwealth Bank of Australia (down 3%), lagging peers and overweights ANZ (up 2%) and QBE (up 6%) fairing better. The Fund had no exposure to AMP (down 8%) or Challenger (down 24%) which issued downgrades. The investment manager believes the value created from growing Challenger's annuity book remains marginal and risky, which is the reason they believe Challenger have largely had this market to themselves.

Underweight postions to defensive REIT's (down 0.15%), telecommunications (down 0.09%) as well as cash (down 0.13%) were a headwind to returns. Stock selection offset the Fund's underweight position to the health care sector where returns are generally dominated by the performance of juggernaut CSL (up 5%).

Resmed (down 18%) lost 20% in two days following a solid second quarter result that fell a bit short of expectations. The Fund exited Resmed back in December due to concerns of valuation risk given the investment manager didn't understand the logic of recent acquisitions and in anticipation of more volatile non-US revenues. Sales of Resmed devices in Japan and France went backwards and a sharp slowdown at Resmed's software business cystallised worries about the $1 billion (in US dollar terms) the company has spent on emerging software plays.

Infrastructure service provider Downer EDI's correlation to the materials sector remains high. Although this was a positive in January (up 6%) it has weighed on longer term returns. As the company demonstrates the progress with the Spotless integration and divests its mining contracting division, the investment manager's expectation is that returns will rise, stock price volatility will decline and the shares should sustainably re-rate.

Qantas fell 6% after Air New Zealand cited weaker leisure demand. Air New Zealand has been increasing its aircraft numbers and so it must find approximately 5% more passengers just to maintain profitability. Qantas has kept its capacity broadly flat which makes short term demand moves more manageable (as demonstrated in the second quarter of 2017) and instead used free cash to buy its shares and entrench its competitive position through route reconfiguration. The Fund increased its position as Qantas' discount to the global sector rose towards 30%.

AGL pushed up another 4%, taking it to $4 per share (up 23%) up from its October low. Higher power prices, defensive earnings and increasing isolation of the Liberal policy position have all contributed to some de-risking. As the debate around energy policy sobers up and the scale of required reinvestment is contemplated, the investment manager expects the market will come to the view that longer wholesale electricity prices are unlikely to fall back to the $60-$65 per megawatt hour, which is what the investment manager believed is implied at $21 per share.

Star Entertainment (down 3%) extended recent weak performance as short term VIP expectations were dialed back, reflecting tighter liquidity in the Chinese shadow banking system which finances the junket operators. VIP is approximately 15% of Star earnings. VIP volatility is hard to pick but the investment manager sees the trend for Chinese demand as going up over time, not down. The stock has been de-rated far beyond the historic sensitivity of player activity to economic conditions, despite lower financial leverage and future on-market buying commitments of key stakeholders.

Market cap distribution

Market cap	Fund (%)	Bench (%)
1- 50	73.17	76.34
51-100	13.72	12.78
101-200	6.64	8.46
201-300	1.86	2.42
Ex 300[1]	1.31	0.00
Cash	3.30	0.00

[1]Including Placement Securities

Top 5 active weights

Security name	Active weight (%)
CSL	-5.51
AGL Energy	3.80
Brambles	3.27
Origin Energy	2.93
Oil Search	2.83

Market outlook

Recent indicators suggest that global growth remains modestly above trend but momentum has weakened over the last several months led by China. Contrary to the investment manager's expectations, the uncertainty and second order impacts around Trump's trade war have damaged corporate confidence and investment. The magnification of this upon financial markets, and the feedback loop this has risked initiating, has escalated the pressure on both sides to resolve it. A timely deal is needed to help rebuild some lost confidence in the global economy. This demonstrates again that post Global Financial Crisis the sensitivity of investors to any moderation in growth still remains deeply entrenched.

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Market outlook (continued)

As always, numerous risks to the growth outlook are present, however, it seems that the sum of the fears exceed the fundamentals. The Federal Reserve's significant step to (all but) announce they will remain solidly behind the curve has quickly reversed much of the tightening in financial conditions observed towards the end of 2018 that risked compounding the slowdown. By switching position so quickly, the Federal Reserve will hold down the US yield curve, and it is underwriting looser liquidity at a time when labor and commodity markets generally remain quite tight. This might support valuation expansion in the short run, yet increases the likelihood of inflationary pressures in the longer-term. The investment manager continues to see the eventual end game of this economic cycle as driven by rising inflation than by 'old age'.

In Australia, the investment manager expects some divergence between housing-linked and other sectors of the economy in 2019. The investment manager doesn't see a significant excess stock of housing, nor expect any further tightening in credit, nor the decline in employment needed to accelerate house price declines and trigger significant flow-on effects to the broader economy. However, the current situation raises the vulnerability to an external macro shock during this adjustment period. This looks less likely after recent developments.

With the precedent set by the Federal Reserve, it is possible that the Reserve Bank of Australia will also take the line of least resistance. With the Federal budget now in surplus running into the election and the continuing improvement in terms of trade supporting national income, fiscal easing is also firmly on the agenda. The pressure on state governments to improve infrastructure means spending is still expected to continue to increase notwithstanding lower stamp duty revenue.

Heightened levels of risk aversion continues to drive many investors towards 'safe' assets offering low real returns. Despite this, the economic backdrop is one that should support earnings growth at or around long-term trend levels. Combined with below trend multiples, equities continue to provide better prospects than fixed income where prospects are largely beholden on inflation remaining low and growth deteriorating.

Within equity markets there remains a cohort of stocks that have driven valuation dispersion to near historic extremes. Given a shortage of genuine growth stocks and a narrow benchmark, Australia has more than its fair share of these stocks. As some renewed loosening global liquidity increases the risk that these valuation differentials continue to widen, the investment manager remains wary that many will struggle to deliver to high growth and margin expectations.

Overall, the Fund remains underweight to interest rate sensitive sectors and is positioned for a more constructive environment than is currently envisaged by the market. The investment manager still sees good risk-adjusted returns available in many sectors. Within this, the emphasis is on quality companies whose prospects are unappreciated by the market.

Key contributors & detractors for the month

Top 5 contributors	Active position
Commonwealth Bank of Australia	Underweight
Origin Energy Limited	Overweight
Rio Tinto Limited	Overweight
Santos Limited	Overweight
Oil Search Limited	Overweight

Top 5 detractors	Active position
Qantas Airways Limited	Overweight
Star Entertainment Group Limited	Overweight
Fortescue Metals Group Ltd	Underweight
Costa Group Holdings Ltd.	Overweight
Telstra Corporation Limited	Underweight

Portfolio characteristics

No of large cap stocks
32

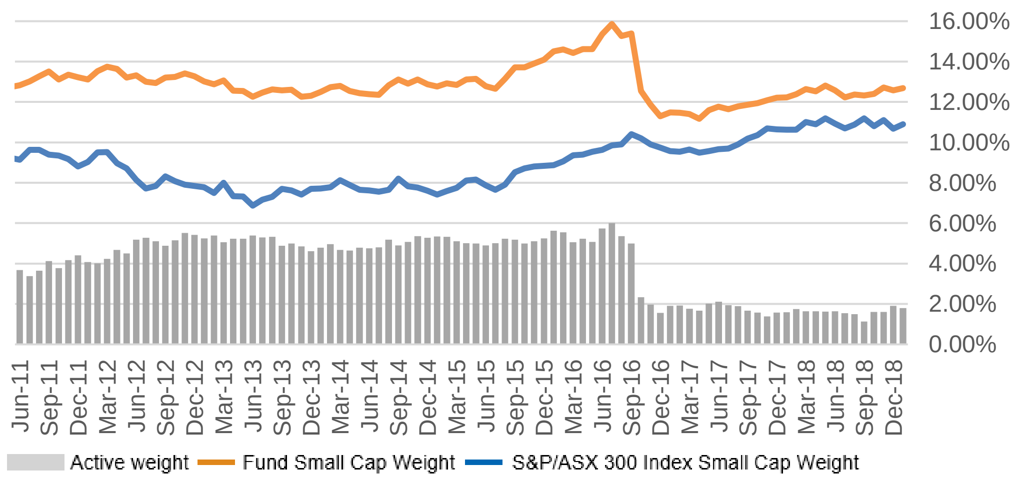
No of small cap stocks
53

Cash
3.30%

Portfolio Turnover (1yr)
45.61%

Sharpe Ratio (1yr)
-0.39

Standard Deviation (5yrs)
11.38%



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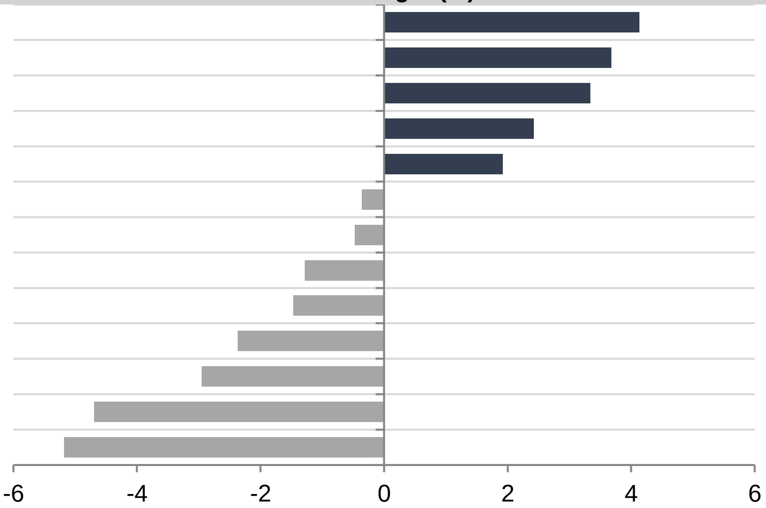
Asset allocation

Sector weights	Fund (%)	Bench (%)
Energy	9.94	5.81
Consumer Discretionary	10.10	6.43
Utilities	5.37	2.04
Industrials	10.43	8.01
Materials ex Metals & Mining	5.40	3.47
Metals & Mining	14.61	14.97
Information Technology	1.85	2.32
Financial ex Property Trusts	29.67	30.96
Consumer Staples	4.26	5.73
Communication Services	1.28	3.65
Real Estate	0.16	3.12
Property Trusts	0.00	4.69
Health Care	3.63	8.80
Cash	3.30	0.00
Total	**100.00**	**100.00**

Active weight (%)



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