Ironbark Karara Australian Share Fund

Monthly Investment Report as at 31 May 2018

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

$61.8m

Exit Price

$1.6339

Market Review

In May, a political crisis in Italy and further evidence of inflationary pressures in the US and Germany contributed to significant bond market volatility. This weighed on European equities, particularly banks, and skittled emerging market equities (-3.8%) as market gyrations pushed investors back towards safe havens. Adding to uncertainty was the unexpected break down in US trade talks and Trump's withdrawal from the Iran nuclear deal. Despite this, many commodity prices saw good gains, supported by some pick up in Chinese growth indicators. The metal and mining sector rose 3.5% as investors sought inflation hedges. A 5% rise in the price of Brent oildid not help the Energy sector much (up 0.4%) as early gains gave way to rising aversion at month end and OPEC telegraphed a potential increase in production quotas. Rising commodities supported a modest appreciation in the Australian dollar ('AUD'), despite broad US dollar ('USD') strength. This confounded short sellers who continue to circle potential causalities of tighter domestic lending conditions and some broadening weakness in local house prices.

This backdrop saw defensively orientatedsectors perform very strongly in the second half of the month, led by health care (up 5.6%). REIT's (up 3.2%) also prospered, boosted by the anticipation of approximately $2 billion Westfield merger proceeds expected to circulate back into the sector early June. Defensive macro thematics did not help the banks (-1.9%) nor telecommunication service (-10.2%) sectors which continued to de-rate on gloomier views of the competitive environment.

The Federal government's budget confirmed the strength of government revenues, its commitment to lower corporate and personal income taxes, and increased infrastructure spending. Employment remained healthy (including hours worked - now up over 5% year-on-year), plant and equipment spending grew at its strongest since the end of the mining boom, and there was a return to growth in miningcapital expenditure. However wages growth continued to be minimal, retail sales were soft and investor mortgage growth slowed to a new low of 2%.

Net market earnings revisions for the 2019 financial year were slightly lower (approximately 0.2%) as downgrades to bank and Telstra outlooks were partially offset by upgrades to mining and energycompanies.

Performance Review

The Ironbark Karara Australian Share Fund (the 'Fund') returned 0.31% (net) for May, underperforming the benchmark's return of 1.19% by 0.88%.

During May, strong contributions came from Qantas (up 10.0%), Oil Search (up 5.5%), Resmed (up 7%), Rio Tinto (up 3.9%) Wesfarmers (up 4.0%), and ANZ (up 4%).

Qantas' quarterly update confirmed strong growth in yields in international as well as domestic sectors. Current revenue growth rates will enable them to comfortably mitigate approximately $700 million of higher fuel costs for the next two years if sustained. Despite strong revenue momentum and a buyback program, which is materially shrinking its shares on issue, the consensus view is for lower earnings per share over the next couple of years.

Performance

	Net Fund Return (%)[3]	Benchmark Return (%)[1]	Active Return (%)
1 month	0.31	1.19	-0.88
3 months	0.38	1.10	-0.72
1 year	9.30	9.99	-0.69
3 years (p.a.)	4.01	6.06	-2.05
5 years (p.a.)	7.39	8.78	-1.39
7 years (p.a.)	7.50	8.18	-0.68
10 years (p.a.)	4.69	4.97	-0.28
Since inception[2] (p.a.)	6.65	7.32	-0.67
Since Karara as Investment Manager (p.a.)	6.56	7.40	-0.84

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.

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

[3]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.

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Performance Review (cont'd)

Diverging bank performances were beneficial to the Fund. ANZ's (up 4%) first half result was a standout amongst the sector, delivering similar revenue growth to peers but holding costs flat and divesting non-core assets and returning capital through a buyback. As a result a sector-leading increase in return on equity is expected. By contrast CBA (underweight, -3.2%) saw its third quarter profit fall 9% as non-interest income shrunk and underlying expenses grew 3% despite a favourable comparative period. Macquarie's (up 8.2%) result was taken well but this benefit was offset by CYBG dropping -7.4% weighed by an optically slightly soft revenue, its general proximity to Italy and uncertainty around the eventual terms of its bid for Virgin Money. The investment manager sees the Virgin tie-up as offering significant funding, scale and market position benefits assuming it can be completed at a fair price.

Also contributing positively was sharp underperformance from Telstra (-12.0%), Treasury Wines (-13.1%), AMP (-3.5%) and A2 Milk (-12.2%) which are not held by the Fund. Both Treasury and A2 Milk pointed to a slowdown in sales into China, which was attributed to a transitory issue with Chinese customs, possibly politically linked. Treasury downplayed press reports of building distribution inventories of lower value wines. However it's not clear why their 'customer pull' distribution model requires intermediaries to take on inventory they don't want. Sales growth expectations into China for both stocks are high leaving them exposed should these issues prove any more substantial.

CSL (up 9.1%) detracted 36 basis points after it delivered an upgrade to guidance. Its market value expended approximately $7 billion in response to a $120 million increase in earnings, despite the upgrade being highly anticipated by investors and in part driven by an atypically virulent flu season. Though the stock has obvious appeal it also has latent risks. The investment manager believes the expanding valuation metrics are the beneficiary of fund flows and aversion towards other large market cap sectors.

Santos fell 4.6% over the month, and 9% from its intra-month peak, after Harbour Energy's $7.00 per share bid was rejected by the Board on value grounds. The investment manager was disappointed with the Santos board over this, believing the 38% premium warranted a shareholder vote. Brambles (-8.5%) continued its underperformance as investors observed rapid increases in timber and transport input prices for CHEP US. Cost recovery will take time but rising pallet costs will further entrench the pallet pooling model, of which CHEP is the scale player. Meanwhile operations elsewhere, which produce the other two thirds of its profits, are performing solidly.

The Fund continued to increase its BHP and CYBG and lightened positions in Crown, Navitas, Resmed, Origin, and Oil Search. Trimming the large energy sector position reflected a jump in the effective oil exposure following the withdrawal of the Santos takeover bid and recognition that the consensus view for the oil outlook has become more optimistic.

Market Cap Distribution

Market Cap	Fund (%)	Bench (%)
1- 50	73.35	75.94
51-100	13.63	12.87
101-200	7.67	8.52
201-300	2.42	2.67
Ex 300[1]	1.36	0.00
Cash	1.57	0.00

[1]Including Placement Securities

Top 5 Active Weights

Security Name	Active Weight (%)
CSL	-5.07
AGL Energy	3.43
Origin Energy	2.88
Brambles	2.48
Rio Tinto	2.38

Key Contributors & Detractors for the Month

Top 5 Contributors	Active Position
Telstra Corporation	Underweight
Qantas Airways	Overweight
Treasury Wine Estates	Underweight
Commonwealth Bank of Australia	Underweight
Oil Search	Overweight

Top 5 Detractors	Active Position
CSL	Underweight
Brambles	Overweight
Incitec Pivot	Overweight
Star Entertainment Group	Overweight
Aristocrat Leisure	Underweight

Market Outlook

Global growth is expected to recover after a slight slowdown in early 2018 even though Europe remains somewhat sluggish. Slack in developed countries is reducing steadily and with above-trend growth expected to continue for some time, the investment manager expects inflation pressures to continue to build. Complacency around longer term inflation risks remains quite high with many expecting any upturn in inflation will be modest despite more evidence of an acceleration of wages in the US and elsewhere. This view, combined with significant concerns around the robustness of growth, continues to support large pools of global capital defensively positioned in assets with low or negative real yields and a preference for long-term defensive growth stocks despite valuations that are extremely high versus history.

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Market Outlook (cont'd)

This positioning has been encouraged by easy financial conditions but which are now either tightening modestly (US) or close to it (EU). Risks are rising that the market is underestimating the extent of tightening that may ultimately be required. However in the near-term, the investment manager anticipates that the key central banks response remains modest as they will welcome inflation that modestly exceeds their targets and as it takes pressure off indebted countries and households.

A strong global earnings outlook combined with a decent gap between earnings and bonds yields provides scope for the stock market to weather somewhat higher interest rates. However, risks to this outlook are rising with the key risks being:

- The sustainability of Chinese growth that has been driven by low returning, debt funded investment. The recent concentration of power may enable a renewed focus on reform to ensure sustainable medium-term growth. The key focus areas are likely to be containing risks, controlling credit growth and advancing reform of state-owned enterprises. This suggests China's deflationary force on global prices will continue to fade. With the services sectors performing strongly, the investment manager expects fiscal and monetary policy to be less impactful on the demand for steel making raw materials modulated going forward.
- The long term willingness of markets to fund rising US budget and current account deficits as the full cost of tax cuts flows through.
- The pursuit of trade tariffs by the US is raising the prospect of widespread escalation, which would have both inflationary and long-term growth implications. Expectations of strong investment growth may be undermined by ill-disciplined short term micro economic policy making.
- Some policy objectives of the new Italian government, such as improving pension equality and reforming taxes, look sensible, however any fiscal expansion will escalate tensions within the EU and creates additional challenges for the European Central Bank. The investment manager expects this will be a slow burn and to remain front of mind for investors and accentuating overvaluation in core European bonds.

Whilst the global growth improvement is relatively synchronised, Australia is lagging. The pickup in domestic economic data over the last year has been encouraging, particularly employment growth, which now appears to be driving a reasonable growth in household income. Going forward, the investment manager expects aggregate consumer spending to be broadly in line with nominal household income growth (approximately 4%) and Australian gross domestic product growth to be slightly above trend at approximately 3%. Strong population growth is assisting headline growth numbers with per-capita growth quite low in a historical context. To this end, the debate on immigration needs close monitoring through the coming election, however at this stage the investment manager expects reductions, and should they occur, to be small.

House prices are moderating with small real price declines occurring due to the tightening in investor credit over the last 12 months. Reasonable owner occupier demand and good employment conditions are preventing a more significant correction. From a high starting point, an orderly adjustment within the context of a broader economy that is performing well is a best case outcome, even if takes several years. Whilst there is risk, the investment manager does not anticipate a material spill over from the housing market into household consumption while employment conditions remain solid. As a small open economy, the key risk to house prices remains external macro shocks which have, if anything, diminished of late.

Moderate global growth and recovery of pricing power in some sectors suggest a reasonable environment for many stocks. However, after the expansion in valuations in recent years, sustained gains will require continuing profit delivery.

Overall market valuation metrics appear quite reasonable in a historical context, however high valuation dispersion exists with a cohort of stocks with defensive growth characteristics extreme by historical standards. This starting point, along with the prospect of higher real bond yields and broadening growth, is increasing the opportunity cost of holding these stocks. Failure by any of these companies to meet or exceed expectations, which is quite common and possibly likely to become more so in an environment of tighter input markets, can be expected to have larger consequences than what has been the case over the past couple of years. The Fund remains materially underweight to this area.

The Fund remains positioned for a more reflationary environment than what is currently priced by the market. The investment manager believes there are good risk-adjusted returns available in many sectors. Within this, the emphasis is on quality companies whose prospects are unappreciated by the market.

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Portfolio Characteristics

No of large cap stocks
33

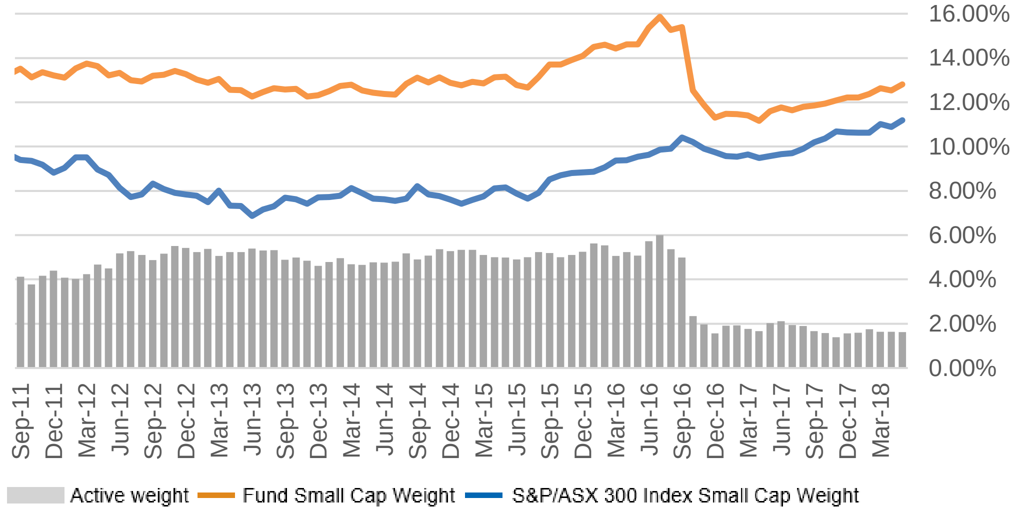
No of small cap stocks
57

Cash
1.57%

Portfolio Turnover (1yr)
35.04%

Sharpe Ratio (1yr)
1.10

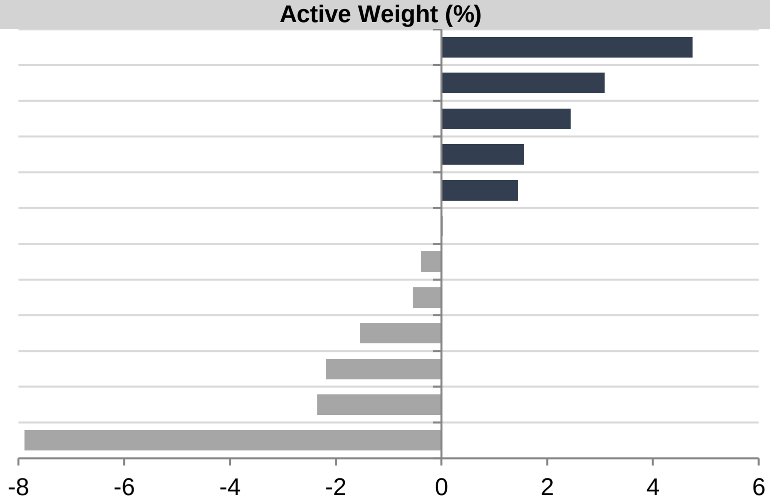
Standard Deviation (5yrs)
11.31%



Asset Allocation

Sector Weights	Fund (%)	Bench (%)
Energy	10.22	5.47
Utilities	5.03	1.95
Consumer Discretionary	7.41	4.97
Materials ex Metals & Mining	5.44	3.87
Industrials	8.92	7.46
Metals & Mining	14.79	14.77
Information Technology	2.05	2.43
Consumer Staples	7.32	7.87
Financial ex Property Trusts	30.59	32.13
Health Care	6.24	8.43
Telecommunications Services	0.07	2.42
Property Trusts	0.35	8.23
Cash	1.57	0.00

Active Weight (%)



Important Information

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