Ironbark Karara Australian Share Fund

Monthly Investment Report as at 31 July 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

$58.8m

Exit Price

$1.6960

Market Review

The S&P/ASX 300 Accumulation Index continued its positive recent run, posting a 1.3% gain through July. Better global performing equity markets and economic data provided a supportive backdrop, more than offsetting a modestly stronger Australian dollar, weaker commodities, and falling Sydney and Melbourne house prices.

During the month, some laggard sectors performed better. Telecommunication services, financial ex property trusts and industrial sectors were the strongest performers (along with the evergreen health care sector). Concerns around Facebook and Netflix earnings guidance coincided with the broadening theme around extreme value/growth divergence and this triggered some tentative rotation out of a few highly rated local favourites.

Mining companies underperformed as financial investors in base metals, gold and energy exited positions in fear of US tariff escalation. Perversely, steel and iron ore prices rose on suggestions that China will quickly adjust fiscal and monetary policy in response to any tariff induced slowing. China also released a three year plan to improve air quality which pointed to a broadening of curtailment measures this winter.

The energy sector gained 1.2% despite a 7% drop in the price of Brent as sell side expectations continued to inch higher. Global oil inventory data continued to decline, however, the rate remains behind the investment manager's expectations and that of 12 months ago. As anticipated, OPEC announced production increases that were largely as anticipated, leaving them with very limited spare capacity.

After heated speculation mid-month, the Bank of Japan took a modest step back from its zero interest rate target. This represented another small but significant step towards normalising global liquidity conditions. Anticipation of this sent US Treasury yields through the 3% mark for an intra-month period, steepening the yield curve in the process. This immediately pressured the NASDAQ and correlated with Australian companies. This had minimal discernable impact on local interest rate sensitive sectors as local yields remained anchored by housing market concerns. REITs returns where marginally positive while utility and infrastructure declined modestly for stock specific reasons.

Commentary from the Reserve Bank of Australia said little to impact markets and at this point they remain happily sidelined. The dollar is consistent with their view of fair value and underlying inflation printed at 1.9% which is just below the bottom end of their band. Although declines in housing prices accelerated (annualised 6% over June and July), credit growth is slowing but still reasonable (approximately 4% year-on-year) despite tighter lending standards. Retail sales are subdued but remain comfortable, with positive growth and employment in July showing some improvement on the recent trend.

Performance

	Net Fund Return (%)[2]	Benchmark Return (%)[1]	Active Return (%)
1 month	1.76	1.31	0.45
3 months	5.34	5.78	-0.44
1 year	14.65	14.70	-0.05
3 years (p.a.)	6.65	8.09	-1.44
5 years (p.a.)	7.68	9.15	-1.47
7 years (p.a.)	9.12	9.79	-0.67
10 years (p.a.)	6.33	6.82	-0.49
Since inception[3] (p.a.)	6.96	7.59	-0.63
Since Karara as Investment Manager (p.a.)	7.05	7.82	-0.77

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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Ironbark ASSET MANAGEMENT

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Performance Review

The Ironbark Karara Australian Share Fund (the 'Fund') returned 1.76% (net) for the month, outperforming the benchmark's return of 1.31% by 0.45%.

The Fund benefited from the trickle down of investor interest into solid industrial companies as the high price-earnings ratio momentum leaders showed some fatigue. Contributions both positive and negative, predominantly came from stock selection.

Positions in Brambles (up 11%), Ansell (up 6%), Qantas (up 9%), Downer (up 9%), Sonic Healthcare (up 6%) and CYBG (up 8%) all saw renewed buyer interest without any notable change in fundamentals. The fixation on spiking lumber and transport costs for Brambles and fuel costs for Qantas both moderated as commodity prices cooled and there was some refocus on underlying franchise strength. The investment manager believes all these companies offer better price to growth characteristics over the medium term than is commonly appreciated.

Incitec Pivot's (up 4%) outperformance was notable despite concerns around the impact drought conditions (Nufarm down 19%, Graincorp down 4%). Incitec's new CEO has recently found pathways through several thorny legacy issues. As well as providing improved certainty around future volumes it has also enabled its buyback to resume. Prices for nitrogen fertilizer, of which Incitec is a substantial producer, have risen sharply since May as Chinese exports have dwindled due to rising coal costs and tightening environmental restrictions.

Detracting from performance was the continuing uncertainty and speculation around energy market intervention. Early in the month the ACCC recommended capping retail pricing to limit differential prices to consumers. This caused AGL and Origin to finish the month 2% and 3% lower, respectively. Whilst the strategy is negative for these companies if adopted, the investment manager would expect the net impact on margins to be offset by lower discounts and lower churn. Such a change would create complexity and risks for governments. The bigger issue for the industry is creating policy transparency for future investment in generation. Absent significant government intervention, the investment manager believes the wholesale electricity price embedded in current share prices is too low.

The other major detractor was a sharp counter trend rally in Telstra (up 8%) which is not held. Investors seemed to take the view that after the recent downgrades the rebased earnings are now realistic. The investment manager tends to agree, subject to implementation of the T22 (Telstra 2022) strategy, however there is uncertainty that great value will be seen even if that end point is reached successfully. The investment manager will be looking for stability and speedy execution from the reshuffled senior management line up.

Through July, the Fund sold down longstanding overweight positions in Macquarie Bank (down 1%) and Resmed (flat). Both were purchased at much lower prices after suffering setbacks that were ultimately hurdled. Both businesses have been performing strongly, however after recent large gains, their prices assume many years of sustained growth ahead.

Macquarie's share of non-annuity or 'lumpy' revenues and profits are running at around twice historical levels. The stock has appreciated on enthusiasm for the short term outlook for these. While the investment manager doesn't see any omen in the change of CEO, they do believe it is less likely that capital market conditions will continue to support Macquarie to the degree required to significantly grow off the current base. The large war chest of unrealised gains will count for less when this occurs.

Resmed's recent revenue growth has been uncharacteristically smooth over the past year which has contributed to a significant re-rating. Earnings per share has accelerated due to headcount reductions from a one-off global reorganisation as well as windfall sales from regulatory changes in Japan and France. Further its current product releases are closer to the end of their life cycle. Therefore, future growth is likely to be less orderly which, if history is a guide, will see its rating tested.

Positions in Aristocrat Leisure, AGL and Star Entertainment Group were added to.

Market Cap Distribution

Market Cap	Fund (%)	Bench (%)
1- 50	72.03	76.69
51-100	15.06	12.63
101-200	6.62	8.26
201-300	2.37	2.42
Ex 300[1]	1.35	0.00
Cash	2.57	0.00

[1]Including Placement Securities

Top 5 Active Weights

Security Name	Active Weight (%)
CSL	-5.16
AGL Energy	3.40
Origin Energy	2.68
Brambles	2.56
Commonwealth Bank of Australia	-2.51

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Market Outlook

Global growth remains strong after the modest slowdown in the first quarter. The investment manager believes this economic cycle has some room to run and is more likely to end from rising inflation in response to tight labour and commodity markets than from 'old age'. This contrasts with the weight of money that, in general, remains defensively positioned in assets offering low real returns due to concerns over the durability of the current expansion.

Risk appetite remains fragile as demonstrated by the recent plunge in emerging markets. But in the real economy there are relatively few signs of excess, and where there is, they seem to be deflating in a relatively benign manner (e.g. local property and Chinese state-owned-enterprise lending).

Central banks are likely to continue to tighten incrementally, yet prefer to remain slightly behind the curve rather than risk facing a re-run of structural stagnation fears. As a result, there is rising risk that the market is ultimately challenged by the emergence of higher inflation.

The outlook for equities appears reasonable with earnings growth at long-term trend levels across a broad range of sectors. Earnings are being capitalised at rates which, in aggregate, are marginally above long term averages. While this does not shout great value, fixed income and other asset classes seem relatively less attractive given they are more reliant on subdued inflation, very low real interest rates and low credit spreads.

Lately, equity markets have been driven by a narrow cohort of stocks resulting in significant valuation dispersion near historic extremes. Yet there have been a number of recent examples of 'market darlings' failing to deliver to the often-lofty embedded expectations, particularly in small caps. The investment manager believes that more variability in relative prices and ultimately a higher cost of money will eventually correct this. Even if this doesn't eventuate, these stocks would be seen as being exposed to falling investor confidence of any form. The Fund remains materially underweight to this area.

A number of risks to the growth outlook are present. While there is the absence of a sizable policy error, these are unlikely to materially impair the current cycle. The Chinese have signaled strongly that they will balance reforms with near-term growth. Even with an irrational escalation of the US-Sino trade war, the direct economic impact remains manageable to China and can be addressed by some re-acceleration in infrastructure investment by China. The second order impacts on corporate confidence are harder to gauge. For now, the markets seem to have been quite measured in how it has treated the escalating tariffs impact. As the fiscal stimulus continues to work its way through the US economy the willingness of markets to fund the widening twin deficits of the US poses another significant risk for markets.

With evidence of ongoing house price declines, investor concerns around the Australian economy is generally cautious. The investment manager's view is that the modest declines in house prices currently being observed are likely to curtail housing investment, but are unlikely to have significant flow on effect to the broader economy. However, the current situation does increase susceptibility to an external macroeconomic shock during the adjustment period.

Technology, along with increased regulatory scrutiny and intervention are threatening longer term growth of most sectors and in some cases dominates investor sentiment. Capital is flowing to the perceived winners and legacy companies are being sent a clear message not to re-invest. The investment manager continues to seek opportunities on both sides of this ledger.

Overall, the Fund is positioned for a more reflationary environment than what is currently priced by the market and we believe that 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.

Key Contributors & Detractors for the Month

Top 5 Contributors	Active Position
Brambles	Overweight
Qantas Airways	Overweight
Downer EDI	Overweight
Insurance Australia Group	Underweight
Sonic Healthcare	Overweight

Top 5 Detractors	Active Position
Telstra Corporation	Underweight
AGL Energy	Overweight
Origin Energy	Overweight
James Hardie Industries	Overweight
Rio Tinto	Overweight

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Portfolio Characteristics

No of large cap stocks
31

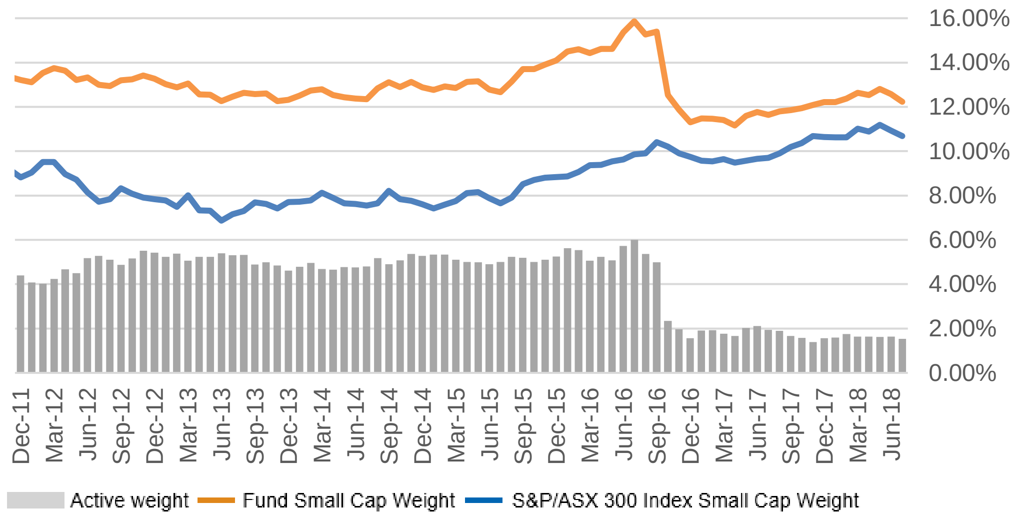
No of small cap stocks
58

Cash
2.57%

Portfolio Turnover (1yr)
35.32%

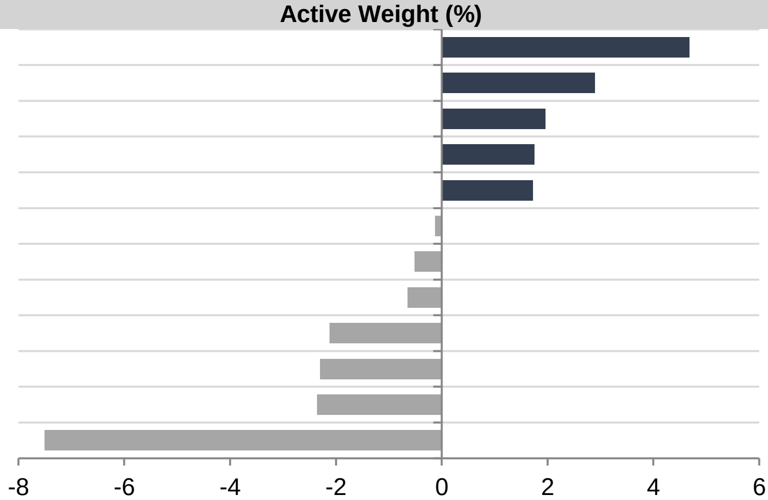
Sharpe Ratio (1yr)
1.74

Standard Deviation (5yrs)
11.05%



Asset Allocation

Sector Weights	Fund (%)	Bench (%)	Active Weight (%)
Energy	10.41	5.74	
Utilities	4.83	1.94	
Consumer Discretionary	6.94	4.97	
Industrials	9.11	7.36	
Materials ex Metals & Mining	5.53	3.81	
Metals & Mining	14.26	14.39	
Information Technology	1.94	2.45	
Consumer Staples	7.29	7.94	
Financial ex Property Trusts	30.72	32.84	
Telecommunications Services	0.07	2.37	
Health Care	6.15	8.50	
Property Trusts	0.18	7.69	
Cash	2.57	0.00	



Important Information

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