



# Ironbark Karara Investment Funds

## Quarterly Investment Report as at 31 December 2018

### Market review

The relatively subdued volatility in financial markets over the past two years ended abruptly during the quarter with the US experiencing its worst December performance since 1931. The S&P 500 unwound year to date gains, falling 14% over the quarter, resulting in a 4.4% fall over the course of 2018. Global equity markets fell by a similar amount with the MSCI World Index producing a negative total return of 13.4%. Australian equity markets losses were marginally better but still recorded a negative total return of 8.4% for the S&P/ASX 300 Accumulation Index.

The quarter begun with a sharp move lower, as high tech and growth companies were hit by a wall of selling. This coincided with higher bond yields and rising expectations of central bank liquidity withdrawal. Tightening financial conditions quickly assumed a self-reinforcing nature and by year-end, markets had concluded a significant further slowdown was inevitable with participant commentary focused on the potential of a recession.

US ten-year government bond yields plummeted back down to 2.68% from a high of 3.26% in October, which was a sharp reversal of the trend of preceding months. Australian ten-year government bonds followed by a similar amount and ended the year at a remarkable 2.32% with the Australian dollar against the US dollar ('USD') falling 2.2% to \$0.7050. Gold also benefited from this flight to safety and finished the quarter at \$1,284 per ounce (in USD terms), which was a 7.4% increase from the end of the September quarter.

Despite the sharp market moves, economic data indicated growth remained above trend. However, weakness in the manufacturing sector and soft external demand emerged across most economies with trade tensions a driver. Trade talks between US President Trump and Chinese President Xi at the start of December made in-principle progress. The growing real economic impact and market volatility have added pressure for both sides to reach a resolution yet consensus starts 2019 expecting little.

The oil market had a precipitous collapse into year-end finishing at \$54.80 per barrel (in USD terms) for Brent, a 35% decline for the quarter. The key development was the larger than expected sanction waivers provided to Iran by the US administration. In anticipation of a tougher stance, OPEC had earlier accelerated production and so this largely ended up in rising inventories. At their meeting in early December, OPEC committed to adjusting production levels to a level that is consistent with a balanced market in 2019 with adjustments to production already visible, however, demand concerns continued to weigh on oil into year end.

Iron ore was mostly immune to the broader growth concerns with it lifting \$2 per tonne during the quarter to \$71.50 per tonne (in USD terms) during the quarter with support arising from an expected pickup in Chinese infrastructure investment. Most other industrial commodities were generally weaker.

Domestically, the impact that both recent house price falls and the fall in equity markets has on consumer spending has become a key focus of investors with the consensus expecting consumers to materially pull back their spending over the coming year. Weak new car sales over the last few months are seen to be the first sign of a change in consumer habits. However, to date outside of new car sales, there has been minimal evidence of a broad shift in consumer behaviour with consumer confidence largely steady presumably on the back of what remains a robust labour market.

### Performance

#### Ironbark Karara Australian Share Fund

Fund size: \$46.6 million

Exit price: \$1.4831

Inception date: 30 June 2005

|                                  | 1 month | 3 months | 1 year | 3 years (p.a.) | 5 years (p.a.) | 7 years (p.a.) | Since inception (p.a.) <sup>3</sup> |
|----------------------------------|---------|----------|--------|----------------|----------------|----------------|-------------------------------------|
| Net fund return (%) <sup>1</sup> | -0.86   | -10.27   | -6.11  | 5.44           | 3.14           | 8.45           | 5.85                                |
| Benchmark (%) <sup>2</sup>       | -0.23   | -8.41    | -3.06  | 6.65           | 5.60           | 9.45           | 6.66                                |
| Excess return (%)                | -0.63   | -1.86    | -3.05  | -1.21          | -2.46          | -1.00          | -0.81                               |

#### Ironbark Karara Australian Small Companies Fund

Fund size: \$593.6 million

Exit price: \$3.3975

Inception date: 30 June 2005

|                                  | 1 month | 3 months | 1 year | 3 years (p.a.) | 5 years (p.a.) | 7 years (p.a.) | Since inception (p.a.) <sup>3</sup> |
|----------------------------------|---------|----------|--------|----------------|----------------|----------------|-------------------------------------|
| Net fund return (%) <sup>1</sup> | -1.82   | -8.24    | -3.66  | 6.63           | 6.21           | 9.49           | 12.37                               |
| Benchmark (%)                    | -4.18   | -13.70   | -8.67  | 7.45           | 5.62           | 4.82           | 3.66                                |
| Excess return (%)                | 2.36    | 5.46     | 5.01   | -0.82          | 0.59           | 4.67           | 8.71                                |

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.

<sup>1</sup>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.

<sup>2</sup>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.

<sup>3</sup>This figure represents the annualised performance of the Fund since inception.

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# Ironbark Karara Investment Funds

## Quarterly Investment Report as at 31 December 2018

### Portfolio performance & portfolio activity

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#### Ironbark Karara Australian Share Fund

The Ironbark Karara Australian Share Fund returned -10.27% (net) during the December quarter. This constituted an underperformance of 1.86% when compared with the S&P/ASX 300 Accumulation Index return of -8.41% for the quarter.

The sharp increase in risk aversion and appetite for defensive stocks was a headwind for the portfolio given the portfolio has been positioned for a constructive economic environment. The lack of exposure to real estate trusts, infrastructure and defensive growth dragged on relative performance during the quarter.

The oil price fall along with a strong aversion to growth exposed areas of the market hit energy stocks hard. Energy holdings Origin (down 22%), Santos (down 25%) and Oil Search (down 21%) all had a significant negative impact on the strategy. Marginally offsetting this was Qantas (down 2%) as analysts start to upgrade earnings as the benefits of lower fuel prices flow through.

The investment manager is not dissuaded by the recent oil price action given they do not share the global growth concerns that have become prevalent in the market, which were clearly impacting on the oil price in December. Share prices are now discounting long-term prices around \$55 per barrel (in USD terms) well below where the investment manager sees long-term sustainable levels. Within the sector, the investment manager continued to reduce Santos in favor of Oil Search and Origin during the quarter. The investment team's visit to Oil Search's operations in Papua New Guinea during November again highlighted the quality of the foundation project and the significant exploration potential that still exists. The market continues to display a reluctance to value their development projects fairly.

AGL snapped its previous streak of underperformance (up 6%) during the quarter as it became apparent that the Federal government's rhetoric had little substance behind it. The energy retailers were not bullied into broad retail margin reductions but did provide some accommodations to standing offer customers. The outcome of the Victorian election and the NSW Liberal government flipping against the Federal government was a critical development that has now set the scene for consensus on emissions between the states and the Commonwealth should Labour win the election.

The overweight to the major miners was a positive with both BHP (down 1%) and Rio Tinto (flat) being rewarded for converting higher commodity prices into higher margins, divesting smaller assets, paying down debt and promptly returning the excess capital. Anticipation that Chinese policymakers will revert to traditional fiscal stimulus is adding to the perception of defensive. Both positions were trimmed following strong relative performance.

CYBG (down 44%) detracted 0.49%, with concerns around Brexit and weak guidance triggering an exodus of Australian investors. The disappointment on the margin guidance stems from discounts that Virgin offered on its UK mortgages in 2017 as well as rising funding costs. Unfortunately, UK licensing delays will push some of the remediation of this into the 2020 financial year. Nevertheless, both these challenges are more than factored into the market given its excellent capital position, high credit quality, large merger synergy opportunity and the very modest 7.2 times earnings multiple.

James Hardie (down 27%) delivered a disappointing result with a downgrade to their guidance for market share gains in the 2019 financial year and a lowering in their margin guidance on the back of increases in input costs. These challenges combined with a weakening outlook for US housing activity took its toll with investors now very cautious about the outlook for the company with the stock trading at a price-earnings ratio of 14 times, well below historical levels. Boral (down 29%) was also impacted by concerns around a weakening housing market and a weak start to the year that makes their prior guidance challenging.

A series of disappointments by non-portfolio holdings Lendlease (down 41%), Bluescope (down 35%) and WorleyParsons (down 41%) made a positive material contribution.

Fallout from the ACCC initial analysis on the TPG and Vodafone merger had a net neutral impact with Telstra (down 11%) and TPG (down 24%). ACCC's desire for a four mobile network market structure seems optimistic at best given TPG is providing no mobile services yet and that both require greater scale to sustainably compete with Telstra and Optus. The investment manager expects that TPG can still convince the ACCC (or the courts) of this, but are mindful of the history which shows the ACCC seldom backs away from its initial findings.

After decent recent performance QBE was marked down 9% after updating the market that the lower cost of their reinsurance arrangements would be offset by a greater loss allowance. A net cost reduction target of \$130 million (in USD terms) by 2021 was also set. Overall this was broadly in line with our expectations. Price weakness was attributed to downgrades due to the up-front restructuring costs and the fall in bond rates. The investment manager was pleased with the update and thinks that QBE is progressing with conservative assumptions along a trajectory of improving margins. The position was increased.

Sonic Healthcare (down 11%) raised \$600 million via a placement to buy an anatomical pathology operator in the US. The acquisition appears reasonable to us as it adds a new capability that should strengthen its existing US operation at a reasonable price. The Fund participated in the discounted capital raising.

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# Ironbark Karara Investment Funds

## Quarterly Investment Report as at 31 December 2018

### Portfolio performance & portfolio activity (continued)

During the quarter, the strategy exited its holding in Resmed (up 1%). Resmed's results have been strong with little slowing evident despite strong comparable period growth. However, expectations are such that this was not enough to revise expectations higher. The investment manager thinks it will be hard for the company to sustain these elevated rates of growth into the medium term and given the premium multiple it now trades on, better opportunities lie elsewhere.

Other Fund activity included a further reduction in Macquarie Group (down 12%), which was initially resilient to market declines. A number of existing positions were added to on weakness.

### Ironbark Karara Australian Small Companies Fund

The Ironbark Karara Australian Small Companies Fund returned -8.24% (net) during the December quarter. This constituted an outperformance of 5.46% when compared with the S&P/ASX Small Ordinaries Accumulation Index return of -13.70% for the quarter.

The strongest contributors to Fund performance at a sector level were overweight positions in metals & mining, utilities and information technology, as well as an underweight position in financials ex property trusts. An overweight position in consumer staples detracted.

At a stock level, positive contributors to monthly performance included overweight positions in Saracen Minerals, Costa Group, Evolution Mining, Meridian Energy and Mercury NZ. A nil holding in Worleyparsons also added to relative performance.

Saracen (up 57%) and Evolution (up 39%) are WA-based mid-tier gold producers with diverse asset portfolios producing at meaningful scale and low cost. Saracen reported strong exploration results from operations and near-mine targets that underpins near-term production guidance of 400 thousand ounces per annum. Evolution is similarly in a strong position as recent acquisitions have been paid down on strong operating performance, leaving the company well-placed to prosper under a range of gold price scenarios. Costa shares gained 4% through the quarter after the company's annual general meeting update confirmed full-year guidance for low-double digit growth. There will be a large second-half skew reflecting avocado and Morocco seasonality, increased Moroccan ownership and additional farming costs, however this has been well flagged. As highlighted at the August result, calendar year 2018 net profit is expected to be down on calendar 2017, however calendar year 2019 earnings are expected to be up 30% on 2018. Meridian (up 9%) and Mercury (up 9%) are both New Zealand-based electricity generators and retailers benefiting from relatively fixed prices for renewable generation and stable operating conditions and competition.

The largest detractors to monthly performance included overweight positions in Bega Cheese, Seven Group and Senex Energy. Bega shares lost 27% after the company guided to lower earnings as a result of lower seasonal volumes due to drought conditions and increased competition for milk. Seven Group shares fell 37% after US-based Caterpillar fell heavily following the release of its 2018 third quarter results, seemingly a function of high market expectations and exacerbated by already weak equity markets generally. On the earnings call, Caterpillar management confirmed Asia-Pacific sales were up 38% on a 12-month basis, a data point that is probably insightful for WesTrac, the Caterpillar dealer in WA, NSW and ACT. Caterpillar noted it saw higher mining equipment sales in the third quarter of 2018 and flagged that strong mining sector rebuild, overhaul and maintenance activity was driving higher aftermarket parts sales. These dynamics are positive for WesTrac and the investment manager remains constructive on Seven Group's exposure to normalisation in Australian mining equipment maintenance following several years of under-investment, as well as the company's exposure to growth in east coast infrastructure investment. Senex shares fell 45% on lower oil prices.

### Top 5 active weights

| Ironbark Karara Australian Share Fund |             |                   | Ironbark Karara Australian Small Companies Fund |                  |                   |
|---------------------------------------|-------------|-------------------|---|------------------|-------------------|
| Security name                         | Sector      | Active weight (%) | Security name                                   | Sector           | Active weight (%) |
| CSL                                   | Health Care | -5.43             | Costa Group Holdings                            | Consumer Staples | 3.71              |
| AGL Energy                            | Utilities   | 3.81              | Saracen Mineral Holdings                        | Metals & Mining  | 3.51              |
| Brambles                              | Industrials | 3.24              | Bega Cheese                                     | Consumer Staples | 2.84              |
| CBA                                   | Financials  | -2.72             | Meridian Energy                                 | Utilities        | 2.35              |
| Origin Energy                         | Energy      | 2.68              | Cooper Energy                                   | Energy           | 2.34              |

### Market outlook

Recent indicators suggest that global growth remains above trend, however, that momentum slipped further in the December quarter. Contrary to the investment manager's expectations, the uncertainty and second order impacts around Trump's trade war have damaged corporate confidence and investment. Markets are now pricing deep concerns that the impacts of further tariffs, and the tightening of financial conditions that have flowed from these, will push economies and earnings into recession in 2019. The investment manager believes this to be unlikely. US economic data suggests growth remains comfortably above 2%. Income growth remains strong, household and corporate balance sheets are in decent shape and this cycle has not created the significant private sector excesses seen before previous hard landings.

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### Market outlook (continued)

While central banks have not recognised or accommodated the trade shock, the investment manager is not of a view that they have over-tightened. The investment manager expects central banks will still need to edge rates higher over time while trying to remain slightly behind the curve. It seems more likely that the eventual end game will stem from modestly rising inflation in response to tighter labour and commodity markets, rather than collapse due to a policy vacuum or through 'old age'. The recent widening in credit spreads will check the risks that were building in credit markets.

The Chinese have signaled strongly that they will balance reforms with near-term growth. Despite the escalation of the US-Sino trade war, even without a quick resolution, the direct economic impact is still seen as manageable to China. However, the market reaction to escalating tariffs risks increases the pressure on both sides to look for the middle ground on the key issues.

Divergent views on the durability of growth suggests a continuing volatile regime for equities yet one where earnings can still grow at or around long-term trend levels. Risk aversion has pushed a large weight of money back towards 'safe' assets offering low real returns. Below trend multiples and reasonable earnings growth suggest equities provide better prospects than fixed income and other asset classes reliant on subdued inflation, low or negative real interest rates and low credit spreads.

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 the significant excess stock of housing, or expect a further tightening in credit or the decline in employment that will be 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.

The likelihood of fiscal easing into the election is supported by the strong budget position. Tax cuts or higher spending would reverse the negative drag seen over the last couple of years where deficit reduction has been prioritised. The significant spending by state governments in infrastructure continues unabated.

Market declines in 2018 have pushed the market multiple back to 14 times, below long run averages. The Fund multiple is comfortably below this. With local long bond yields of 2.3%, the implied equity risk premium has continued to rise. Unless widespread downgrades emerge, this should ultimately be supportive for returns.

Within equity markets there remains a cohort of stocks that have supported benchmark and valuation dispersion to near historic extremes. A shortage of genuine growth stock and a narrow benchmark means Australia has more than its fair share of these. Given the recent reset of sentiment, and as global liquidity continues to tighten over time, the investment manager expects those that do not deliver to high growth and margin expectations will become much more sensitive to disappointment.

As always, numerous risks to the growth outlook are present, however, it seems to the investment manager that the sum of the fears exceeds the fundamentals.

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 over the quarter

#### Ironbark Karara Australian Share Fund

| Top 5 contributors | Active position | Top 5 detractors        | Active position |
|--------------------|-----------------|-------------------------|-----------------|
| AGL Energy         | Overweight      | CYBG                    | Overweight      |
| Woodside Petroleum | Underweight     | Origin Energy           | Overweight      |
| Lendlease Group    | Overweight      | Oil Search              | Overweight      |
| Rio Tinto          | Overweight      | James Hardie Industries | Overweight      |
| Qantas Airways     | Overweight      | Santos                  | Overweight      |

#### Ironbark Karara Australian Small Companies Fund

| Top 5 contributors       | Active position | Top 5 detractors     | Active position |
|--------------------------|-----------------|----------------------|-----------------|
| Saracen Mineral Holdings | Overweight      | Bega Cheese          | Overweight      |
| Worleyparsons            | Underweight     | Regis Resources      | Underweight     |
| Costa Group Holdings     | Overweight      | Seven Group Holdings | Overweight      |
| Evolution Mining         | Overweight      | Senex Energy         | Overweight      |
| Meridian Energy          | Overweight      | LiveTiles            | Overweight      |

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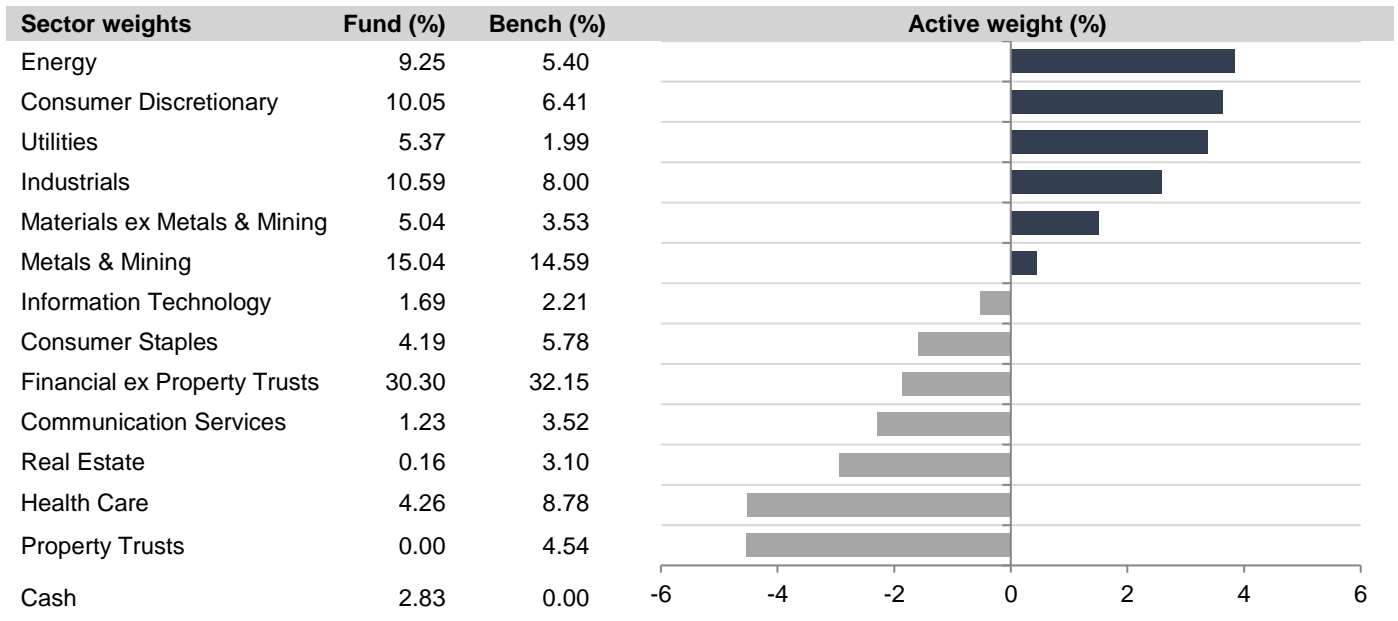


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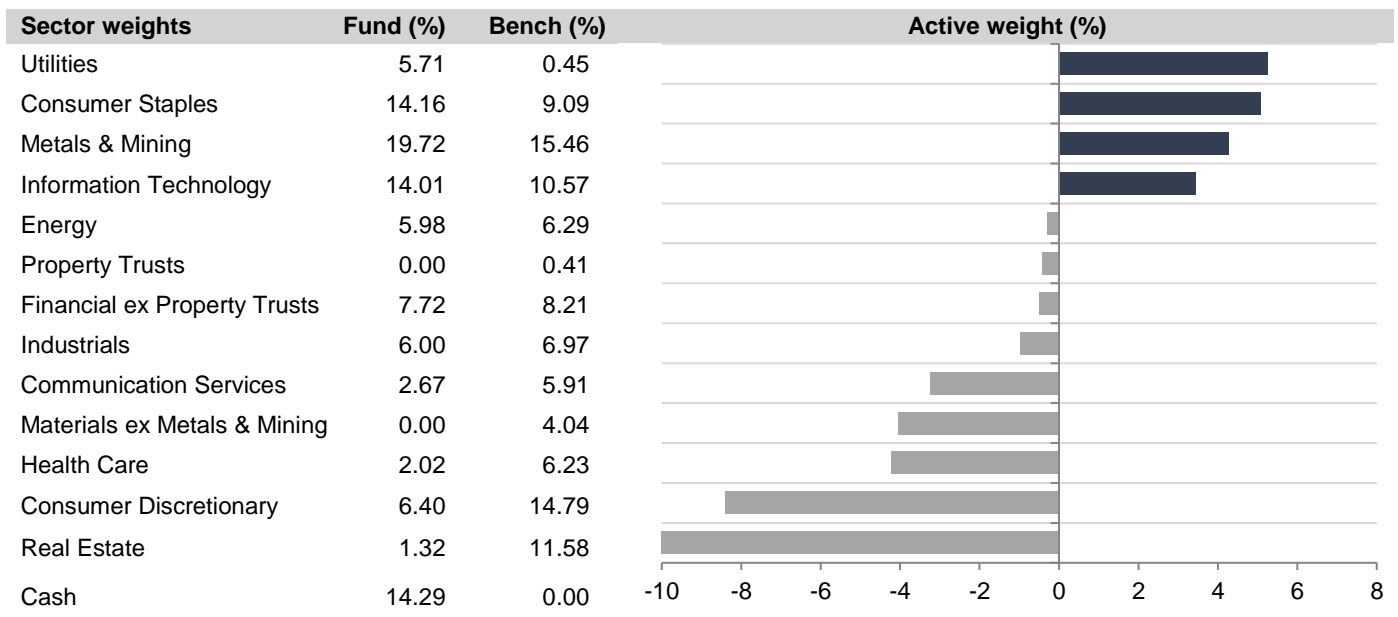
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## Asset allocation

### Ironbark Karara Australian Share Fund



### Ironbark Karara Australian Small Companies Fund



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