Ironbark Karara Investment Funds

Quarterly Investment Report as at 30 September 2018

Market Review

The September quarter saw a significant rotation away from emerging markets and towards the US with the US equity market being the pillar of strength (S&P 500 up 7.2%). The S&P/ASX 300 Accumulation Index delivered a 1.5% total return, which was broadly in line with the MSCI All Country World Index excluding the US.

The rotation away from emerging markets was driven by the uncertainty stemming from the escalating trade dispute between US and China, rising interest rates and idiosyncratic issues in Argentina and Turkey. Commodities were impacted with significant declines in copper and other industrial metals. Iron ore bucked the trend and finished up 7.2% over the quarter at $69.70 per ton (in US dollar 'USD' terms) on the expectation that the Chinese government would ensure no broader economic impact from the imposed tariffs by accelerating infrastructure activity.

Emerging market concerns had minimal impact on oil as the implications from the reinstatement of sanctions on Iran came into clearer focus lifting Brent 4.1% to $82.70 per barrel (in USD terms). The rise in Australia's key commodities (oil-linked liquid natural gas and iron ore) was insufficient to stop the Australian dollar falling against the US dollar with AUD/USD down 2.4% to 0.7224, however, on a trade weighted basis the currency was largely flat.

Concerns escalated around the unintended consequences arising from Hayne's Royal Commission. The bearish narrative focuses on further tightening of system wide credit availability on the back of heightened verification activity of household expenses. Commentary from policy makers demonstrate full awareness of the issues with repeated reassurances of no desire to tighten credit availability further. To date, house lending activity in 2018 is exceeding expectations held at the start of the year with owner occupiers more than offsetting the retreat of the investor. However, the major banks continue to lose share to non-bank lenders presumably due to more restrictive underwriting standards.

Domestic employment conditions remain strong with trend employment growth running at 2.5% year-on-year. The growth in employment has reduced the unemployment rate to 5.3% as of August. Whilst wages are showing minimal pressure currently, wage pressure is building with many lead indicators suggesting wage inflation pick up to occur over the next 12-18 months.

Contrary to many concerns around the domestic consumer over the last several months, the strength in the employment market is outweighing the impact of the modest decline in house prices with wealth still appreciably higher on a multi-year view. Consumer confidence took a hit following the leadership turmoil in Canberra in August but largely recovered in September. To date, neither aggregate data nor company feedback is yet to suggest any weakening in consumer spending.

Performance

Ironbark Karara Australian Share Fund

Fund size: $56.2 million **Exit Price: $1.6889** **Inception date: 30 June 2005**

	1 month (%)	3 months (%)	1 year (%)	3 years (pa) (%)	5 years (pa) (%)	7 years (pa) (%)	Since inception[3] (pa) (%)
Net Fund Return[1]	-0.55	1.33	13.70	10.98	6.23	10.64	6.84
Benchmark[2]	-1.19	1.50	14.03	12.16	8.19	11.16	7.50
Excess Return	0.64	-0.17	-0.33	-1.18	-1.96	-0.52	-0.66

Ironbark Karara Australian Small Companies Fund

Fund size: $645.6 million **Exit Price: $3.7312** **Inception date: 30 June 2005**

	1 month (%)	3 months (%)	1 year (%)	3 years (pa) (%)	5 years (pa) (%)	7 years (pa) (%)	Since inception[3] (pa) (%)
Net Fund Return[1]	-0.99	-0.82	17.20	12.42	8.52	11.17	13.35
Benchmark	-0.35	1.10	20.32	16.97	8.75	6.96	4.88
Excess Return	-0.64	-1.92	-3.12	-4.55	-0.23	4.21	8.47

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]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.

[2]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.

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

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Ironbark ASSET MANAGEMENT

Market Review (cont'd)

Reporting season sparked historically high volatility and dispersion in sector returns. Results themselves were generally more muted with profit surprises, particularly positive ones, low in number and magnitude while forward earnings growth was trimmed by less than 1%, to around 5%. Cost pressures being faced consistent with higher commodity prices and a tightening labour market are placing mild pressure on margins.

Elevated investor risk aversion continues to support strong appetite throughout most of the quarter for health care and information technology stocks albeit some of the significant gains seen in August were substantially unwound in September. Measures of valuation dispersion remain wide.

Portfolio Performance & Portfolio Activity

Ironbark Karara Australian Share Fund

The Ironbark Karara Australian Share Fund returned 1.33% (net) during the September quarter. This constituted an underperformance of 0.17% when compared with the S&P/ASX 300 Accumulation Index return of 1.50% (net) for the quarter.

Brambles bounced back sharply during the quarter (up 24%) as the company delivered a solid result and investors begun to acknowledge that the margin impact from rising input costs in the US is only likely to be temporary. The European business continued to outperform the investment manager's expectations.

QBE (up 17%) is benefiting from the new CEO undertaking an intensive re-engineering of their underwriting practices. The investment manager increased the Fund's position further.

JB Hi-Fi (up 14%) continues to deliver solid sales growth but suffered margin contraction in The Good Guys following a period of seemingly irrational competitor activity. The investment manager remains impressed with their execution across the business and see strong progress in reshaping management systems, sourcing and store formatting at The Good Guys, which will ultimately enable market share gains and much improved returns.

Other strategy holdings that delivered solid results included Boral (up 8%), Downer (up 19%), Star Entertainment (up 8%) and Suncorp (down 1%).

The merger between Vodafone and TPG (up 65%) is an industry changing event and the investment manager expects that industry competition is likely to now be rational going forward, thereby providing Telstra (up 26%) some competitive reprieve. The investment manager expects mobile industry pricing can improve in the longer term as the three remaining mobile networks seek to obtain an adequate return on substantial capital underpinning the sector. It was the substantial synergies from the merger and the potential for industry returns to improve that underpinned the addition of TPG to the Fund.

Qantas (down 3%) came under pressure on the back of the increase in oil prices with investors fixated on its fuel bill recovery challenge in the 2019 financial year rather than the bigger picture, which is that its experienced, return oriented management team has the whip hand in a solid duopoly. The position was marginally increased post the result.

The failure of the Federal Government to implement the strongly supported National Energy Guarantee, and its decision to place the retailers in the firing line despite the ACCC not finding any untoward behavior drove a crisis in confidence towards both Origin (down 18%) and AGL (down 11%), which collectively were the largest detractor's during the quarter. Origin did itself no favours as well by changing the treatment of recurring electricity hedge costs ($160 million) previously taken below the line. The investment manager is disappointed by the prior treatment and the failure to adequately disclose this in the past.

Both AGL and Origin are now firmly out of favour given energy policy uncertainty and concerns of irrational policy being implemented that may have short term populist appeal. The announced policy of the introduction of retail reference pricing is likely to be benign if the ACCC's proposed methodology is adopted. The investment manager struggles to see any plausible intervention in the wholesale market that can sustainably lower wholesale prices with the uncertainty that has now been created only serving to increase the sector's cost of capital at a time where investment is required.

Santos' (up 17%) purchase of Quadrant Energy for $2.9 billion cash was well received by the market with the company now back on a growth footing. Whilst the investment manager views Quadrant as complimentary, they do not see it as a bargain. The position has been reduced in favour of Oil Search and Origin. Oil Search has by far the highest quality growth pipeline of the sector with significant value in the expansion of Papua New Guinea Liquid Natural Gas yet to be fully recognised by the market.

During the quarter the investment manager sold down longstanding overweight positions in Macquarie Bank (up 2%) and Resmed (up 13%). Both were purchased at much lower prices after suffering setbacks that were ultimately hurdled. Both businesses have been performing very strongly but 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.

Portfolio Performance & Portfolio Activity (cont'd)

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 re-organisation as well as windfall sales from regulatory changes in Japan and France. Furthermore, its current product releases are closer to the end of their life cycle. Therefore, the investment manager sees future growth is likely be less orderly, which, if history is a guide, will see its rating tested.

Other fund activity included additions to Aristocrat Leisure and Star Entertainment.

Ironbark Karara Australian Small Companies Fund

The Ironbark Karara Australian Small Companies Fund returned -0.82% (net) during the September quarter. This constituted an underperformance of 1.92% when compared with the S&P/ASX Small Ordinaries Accumulation Index return of 1.10% (net) for the quarter.

During the quarter, the strongest contributors to fund performance at a sector level were an overweight position in information technology and an underweight position in materials ex metals & mining. Overweight positions in consumer staples and metals and mining detracted.

At a stock level, positive contributors to quarterly performance included overweight positions in Altium, Bapcor and Technology One. A nil holding in Regis Resources and Sims Metal also added to performance.

Shares in Altium rose 22% after the company reported another strong result with operating metrics tracking comfortably to financial year 2020 guidance. Management set a new target of reaching 100,000 subscribers by 2025, up from 37,000 currently, likely positioning the company as the global leader in Printed Circuit Board design software and also foretold of a much larger opportunity to move into the electronic parts market in the medium term. Bapcor shares rose 18% after delivering a solid result during reporting season with all parts of the business delivering to strategy, specifically, solid like for like sales trends, network expansion, and gross margin improvement. The medium term outlook is underpinned by further network expansion and continuing organic growth through private and own brand penetration, scale benefits, and warehouse and supply chain optimisation. Technology One shares rose 31% after the company confirmed implementation of new accounting standard IFRS 15 would have negligible impact on profits and free cash flow, alleviating some of the markets' concerns towards the stock.

The largest detractors to quarterly performance included overweight positions in Costa Group and Saracen. Costa shares fell 12% after the company's 26% net profit growth in the 2018 financial year missed lofty consensus estimates by 6%. The miss reflected climatic challenges across a few of the company's domestic and international berry operations. More specifically a seasonal delay in Morocco which impacted both blueberry volumes and quality, while poor conditions in northern Queensland and Tasmania during the highly profitable "shoulder season" affected Australian blueberry profits. Costa's guidance is for "low double-digit" net profit growth over the 2018 financial year as well as over a three-to-five year time horizon, highlighting the strength and diversity of the company's operations. Saracen fell 15% after strong out-performance in the June quarter in the face of a weaker gold price gave way to some mean reversion.

Top 5 Active Weights

Ironbark Karara Australian Share Fund

Security Name	Sector	Active Weight (%)
CSL	Health Care	-5.30
AGL Energy	Utilities	3.01
Brambles	Industrials	2.97
Origin Energy	Energy	2.54
Rio Tinto	Materials	2.50

Ironbark Karara Australian Small Companies Fund

Security Name	Sector	Active Weight (%)
Bega Cheese	Consumer Staples	3.70
Costa Group Holdings	Consumer Staples	3.56
Altium	Information Technology	2.88
Bapcor	Consumer Discretionary	2.35
Cooper Energy	Energy	2.19

Market Outlook

The global growth outlook 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.

Central banks are likely to continue to tighten incrementally but conditions remain loose and policymakers will 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.

Market Outlook (cont'd)

Equity markets have been driven by a narrow cohort of stocks resulting in significant valuation dispersion near historic extremes. Reporting season saw a number of 'market darlings' failing to deliver to the often-lofty earnings growth expectations with costs to deliver high revenue growth being frequently underappreciated. In many cases, share prices were surprisingly insensitive to this disappointment. 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 are seen as 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. Absent a sizable policy error, the investment manager believes 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.

The US fiscal expansion that is currently underway is supporting activity in the US and is likely to continue for some quarters. However, the investment manager is concerned by the size of the US twin deficits and sees the need for the US to maintain and attract larger amounts of foreign capital in the future as generating a significant risk for markets in the longer-term.

With evidence of ongoing house price declines, investors' concerns around the Australian economy is cautious. The investment manager believes that the modest falls in house prices currently being observed is likely to modestly curtail housing investment but is unlikely to have significant flow-on effects to the broader economy. However, they do note that the current situation does increase the susceptibility to an external macro shock during this adjustment period.

Potential for future fiscal easing exists as government revenues have showed a marked improvement on the back of better commodity prices and stronger labour markets. The likely prospect of tax giveaways or higher spending will reverse the negative drag seen over the last few years where deficit reduction has been prioritised. The significant spend by state governments on infrastructure continues unabated with the pipeline growing as Victoria and New South Wales head to the polls over the coming six months.

The oil market is expected to remain in deficit throughout 2019 due to Iran exports falling by 1 to 1.2 million barrels per day, infrastructure constraints in the Permian Basin, and a disciplined OPEC that continues to be focused on maximising revenue. Going forward, spare supply capacity is limited (and largely concentrated in Saudi Arabia) with future supply disruptions poised to deliver a sharp increase in oil prices.

Overall, the Fund is positioned for a more reflationary environment than what is currently priced by the market and the investment manager believes 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 over the Quarter

Ironbark Karara Australian Share Fund

Top 5 Contributors	Active Position
Brambles	Overweight
Santos	Overweight
Downer EDI	Overweight
JB Hi-Fi	Overweight
QBE Insurance Group	Overweight

Top 5 Detractors	Active Position
Origin Energy	Overweight
Telstra Corporation	Underweight
AGL Energy	Overweight
Woodside Petroleum	Underweight
CSL	Underweight

Ironbark Karara Australian Small Companies Fund

Top 5 Contributors	Active Position
Altium	Overweight
Regis Resources	Underweight
Bapcor	Overweight
Sims Metal Management	Underweight
Technology One	Overweight

Top 5 Detractors	Active Position
Costa Group Holdings	Overweight
Saracen Mineral Holdings	Overweight
Wisetech Global	Underweight
Elders	Overweight
Pantoro	Overweight

Ironbark Karara Investment Funds

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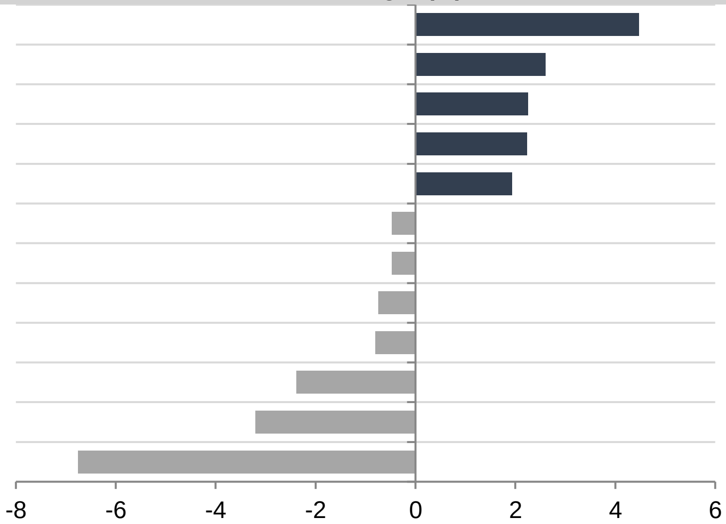
Asset Allocation

Ironbark Karara Australian Share Fund

Sector Weights	Fund (%)	Bench (%)
Energy	10.47	6.00
Consumer Discretionary	6.93	4.33
Industrials	9.99	7.74
Utilities	4.11	1.87
Materials	19.83	17.90
Consumer Staples	7.36	7.83
Information Technology	1.85	2.33
Financial ex Property Trusts	31.18	31.92
Diversified	0.00	0.80
Communication Services	1.41	3.80
Health Care	5.39	8.60
Property Trusts	0.14	6.89
Cash	1.33	0.00

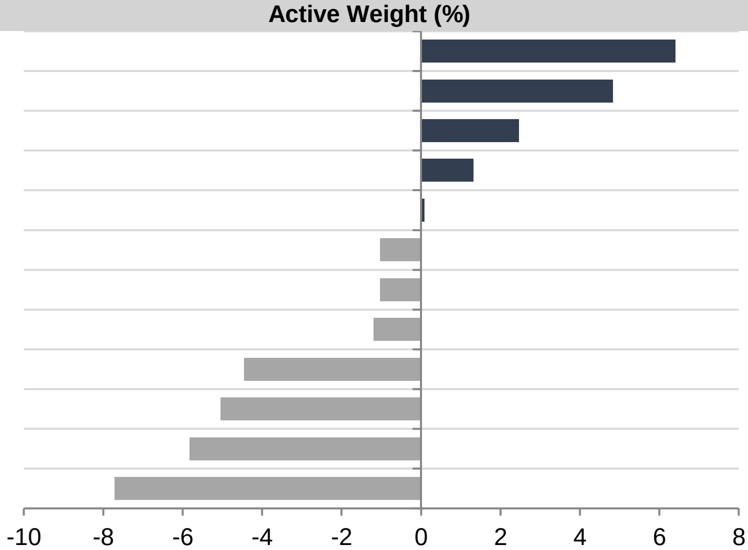
Active Weight (%)



Ironbark Karara Australian Small Companies Fund

Sector Weights	Fund (%)	Bench (%)
Consumer Staples	14.81	8.41
Information Technology	15.53	10.71
Utilities	2.92	0.46
Energy	9.67	8.35
Industrials	7.86	7.78
Financial ex Property Trusts	7.42	8.44
Materials	15.90	16.92
Diversified	0.00	1.19
Health Care	2.32	6.76
Communication Services	3.62	8.66
Consumer Discretionary	7.58	13.40
Property Trusts	1.20	8.92
Cash	11.17	0.00

Active Weight (%)



Important Information

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