# Ironbark Karara Australian Share Fund

## Monthly Investment Report as at 31 August 2017

**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]

**Buy/Sell Spread**

+0.25%/-0.25%

**Management Costs**

0.9925% p.a.[2]

**Distribution Frequency**

Semi-Annually

**Minimum Investment**

$20,000

**Fund Size**

$78.1m

**Exit Price**

$1.5190

### Market Review

The S&P/ASX300 Accumulation Index slightly improved in August, rising 0.75%. Global stock markets were also slightly higher overall led by supportive global growth and earnings, rather than Trump's utterings and North Korean aggression. Equity investors seemingly interpret the status quo (lots of turmoil but no meaningful change to economic policy settings) as relatively benign.

This saw unusual divergence between commodities and emerging markets on one hand and bond yields. Although low inflation readings also helped US Treasuries (10 year bonds, down 1 basis point), there was seemingly some benefit from the safe haven bid. Gold rose 4%, however copper, aluminum and zinc hit multi-year highs after Chinese Purchasing Manager's Index data surprised with stronger output and orders.

Although backwards looking, the June quarter global growth rates were notable with 2.5% in the European Union, 3.0% in the US and 4% in Japan. Global growth at 3.8% was the strongest since 2010.

Oil went sideways despite strong draws in US crude inventories and declines in US onshore production and rig numbers.

Stock and sector volatility was high as most companies reported results for the period ended June. Initial price reactions were often perverse, as poor results were rewarded for being less bad than feared, and vice versa. Many then reverted to trend, with a number of highly rated stocks performing well despite downgraded forward outlooks. This reflects the overall scarcity of 'sustainable' growth and lack of confidence much beyond that.

The standout sectors were the metals and mining (up 5.5%) and energy sectors (up 5.2%) which are seeing sharply improved margins from higher prices and cost reductions.

Results for industrial companies were below expectations to an unusually large extent. Prospective margins are being challenged by domestic energy costs, some increases in total labour cost and slower realisation of IT investment efficiencies. Overseas exposed companies generally did not see the benefit expected from the stronger growth environment due to market share loss, foreign exchange movements and rising selling, general and administration expenses.

Estimates for forward earnings fell 0.2% in aggregate, however divergence at the sector level is clearly apparent: resources were marked up (1.7%) and banks (0.7 %), but the insurance sector was cut (-5.0%) and industrials were marker (-1.8%) lower.

Consensus now expects an earnings per share growth of 4.5% for the next 12 months. As all sectors are expected to show some growth this year and forecasts for resources are currently well below spot prices, this seems an unusually realistic starting point.

### Performance

| | Net Fund Return (%) | Benchmark Return (%) | Active Return (%) |
|---|---|---|---|
| 1 month | 0.11 | 0.75 | -0.64 |
| 3 months | 0.22 | 0.99 | -0.77 |
| 1 year | 8.31 | 9.54 | -1.23 |
| 3 years (pa) | 2.73 | 5.16 | -2.43 |
| 5 years (pa) | 9.64 | 10.41 | -0.77 |
| 7 years (pa) | 7.92 | 8.40 | -0.48 |
| 10 years (pa) | 2.78[4] | 3.56[1] | -0.78[4] |
| Since inception[3] (pa) | 6.31[4] | 7.03[1] | -0.72[4] |
| Since Karara as Investment Manager[4] (pa) | 5.99 | 6.93 | -0.94 |

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. Retail investors should refer to net returns. If investing through an IDPS Provider, the total after fees performance return of your investment in the Fund may be different from the information in this report.

[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] For a full breakdown of management costs, refer to the PDS dated 30 November 2015.

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

[4]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 & Fund Activity

The Ironbark Karara Australian Share Fund (the 'Fund') returned 0.11% (net) over the month, underperforming the benchmark's return of 0.75%, by 0.64%.

Over the month energy positions were the strongest contributors. Origin (up 10.6%), Santos (up 10.9%) and Oil Search (up 1.1%) each guiding to production costs improvement. The extent for Santos was material, with drilling costs falling from US$1.5 million to $0.9 million per well. Origin acknowledged that it is well behind GLNG's (Santos) efficiency and has implemented a program to redress. The free cash flow from both companies implies debt reduction targets should be comfortably exceeded before any assistance from commodity prices.

Downer (up 12%) and Qantas (up 7.5%) both reported high quality numbers. Qantas confirmed strong domestic yield realisation, moderating international competition and disciplined cost and capital management. A $90 million per annum benefit from re-jigging their alliance with Emirates hinted at the long term potential of non-stop flights to Europe. Downer EDI's guidance was 3% ahead of expectations however more significantly it expressed confidence in its newly acquired Spotless businesses. Work-in-hand is recovering as mining, rail, infrastructure and utility sector activity lifts. From the 2019 financial year, each division will be placed to grow, conditions not seen for a decade.

Falls in CBA (-6.6%) and Telstra (-6.6%) benefitted the Fund as management strategies ultimately came unstuck. Telstra acknowledged that dividends are not independent of underlying earnings. The company still hopes to hold a 22 cents dividend (lowered from 31 cents) which will require a significant increase in mobile profits. This seems a tall order given Telstra's high starting market share, declining network advantage and a dynamic new entrant.

Revelation of CBA's repeated failures to meet AUSTRACs reporting requirements look to have catalysed a period of significant management turmoil. If prior bank saga's are repeated this change will be protracted and dampen operating effectiveness, even if the organisation will ultimately be better for it.

The largest detractor was the combined impact of not holding Transurban (up 6.6%) or Sydney Airport (up 10.0%). Reported results were solid although contained little new information. Each has now fully recovered from last year's declines in spite of higher domestic bond yields. Flow of funds from other defensives (namely Woolworths, Coke Amatil, Telstra and CBA over the past 18 months) has extended valuations.

Detracting from performance were negative market reactions to results from James Hardie (-7.7%), Crown (-8.8%), Navitas (-7.2%) and insurers Suncorp (-6.0%) and QBE (-10.1%).

James Hardie brought on new production capacity and resolved plant unit costs however lost some sales momentum while product was in short supply. Meanwhile while hurricane damage might disrupt sales in Texas and Florida in the very short term, medium term demand should be enhanced.

Crown did not meet expectations for further cost reductions or portfolio restructuring. Earnings improvement requires normalisation of VIP junket play and mass market Perth demand. The pre-conditions for this are in place but will take some time.

Navitas' student enrollment growth is accelerating per expectations although the final profit contribution from Macquarie University was above prior guidance.

Suncorp and QBE price falls were outsize reactions to modestly lower guidance (approximately 4%). This reflects fatigue with the sector which has experienced claim deterioration and higher operating costs than promised. QBE, trading at book value, commenced a buyback.

A small residual position in Telstra was sold, Suncorp was reduced and positions in James Hardie, Ansell, Wesfarmers, BHP and Rio Tinto were added to.

### Market Cap Distribution

| Market Cap | Fund (%) | Bench (%) |
|---|---|---|
| 1- 50 | 70.89 | 78.60 |
| 51-100 | 13.93 | 11.26 |
| 101-200 | 7.63 | 7.51 |
| 201-300 | 1.79 | 2.63 |
| Ex 300[1] | 1.63 | 0.00 |
| Cash | 4.13 | 0.00 |

[1]Including Placement Securities

### Top 5 Active Weights

| Security Name | Active Weight (%) |
|---|---|
| CSL | -3.77 |
| AGL Energy | 3.25 |
| Telstra Corporation | -2.82 |
| Origin Energy | 2.55 |
| Brambles Limited | 2.14 |

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### Market Outlook

The broad-based pickup in global growth indicators and inflationary expectations are moderating somewhat, although above-trend growth is occurring and this is expected to continue. Large pools of global capital remain sidelined in low yielding assets and will take time to re-position as confidence over the durability of recovery continues to build.

Slack in the US economy and labour market is now relatively low and the investment manager expects that the Federal Reserve will slowly raise rates given overall financial conditions are easing further through a weaker currency and strong equity market. Structural limits on US growth mean that they will likely have some tolerance around inflation exceeding their targets as wage inflation picks up.

Bond yields seem overly depressed given the underlying economic momentum that is currently being observed, which is also currently manifesting itself through increases across the commodity complex. However, with the global earnings outlook improving and a decent gap between earnings and bonds yields, there is scope for the stock market to weather somewhat higher interest rates. The key macro risks remain twofold:

- The sustainability of debt driven Chinese growth. Given the success of 2016's stimulatory efforts, the Chinese Government's focus has moved judiciously towards containing risks, controlling credit growth and advancing reform. The investment manager expects policy to be more modulated going forward and overall less supportive for steel making materials.

- The structural challenges in Europe remain unresolved. Better growth and recent electoral outcomes are encouraging but adverse political risks remain omnipresent.

### Portfolio Characteristics

**No of large cap stocks**
35

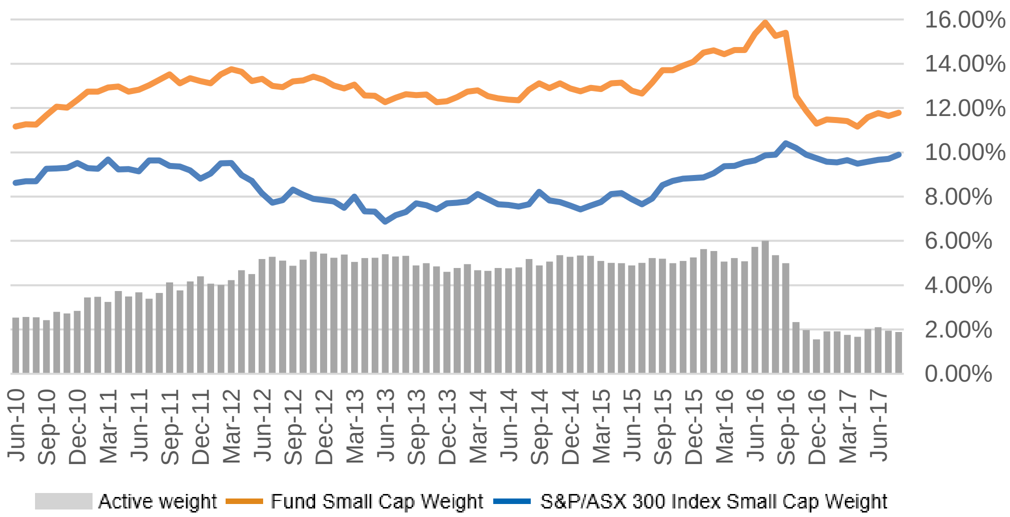
**No of small cap stocks**
57

**Cash**
4.13%

**Portfolio Turnover (1yr)**
53.78%

**Sharpe Ratio (1yr)**
0.92

**Standard Deviation (5yrs)**
11.79%




### Key Contributors & Detractors for the Month

| Top 5 Contributors | Active Position |
|---|---|
| Origin Energy | Overweight |
| Downer EDI | Overweight |
| Commonwealth Bank of Australia | Underweight |
| Telstra Corporation | Underweight |
| Santos | Overweight |

| Top 5 Detractors | Active Position |
|---|---|
| James Hardie Industries | Overweight |
| JB Hi-Fi | Overweight |
| Vocus Group | Overweight |
| Crown Resorts | Overweight |
| Navitas | Overweight |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### Market Outlook (cont'd)

Whilst the global growth improvement is relatively synchronised, Australia is lagging. The investment manager anticipates that Australian gross domestic product ('GDP') growth will remain modest at around 2-3%. Strong population growth is assisting headline growth numbers with per-capita growth quite low in a historical context.

The recent pickup in domestic economic data is encouraging, particularly the recent employment data. Overall, the investment manager expects aggregate consumer spending to be broadly in line with household income growth (3-4%), which is still low in a historical context. Further strength in the Australian dollar could jeopardise this.

House prices are high by any measure and conditions in the housing market vary considerably outside of Melbourne and Sydney. The recent tightening of credit to the investor segment of the market appears to be having a somewhat cooling impact on the housing market with a reasonable likelihood of small real price declines over the next couple of years. 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 the return of pricing power in some sectors suggest a reasonable backdrop for many stocks. However, after the expansion in valuations in recent years, sustained gains will require continuing profit delivery.

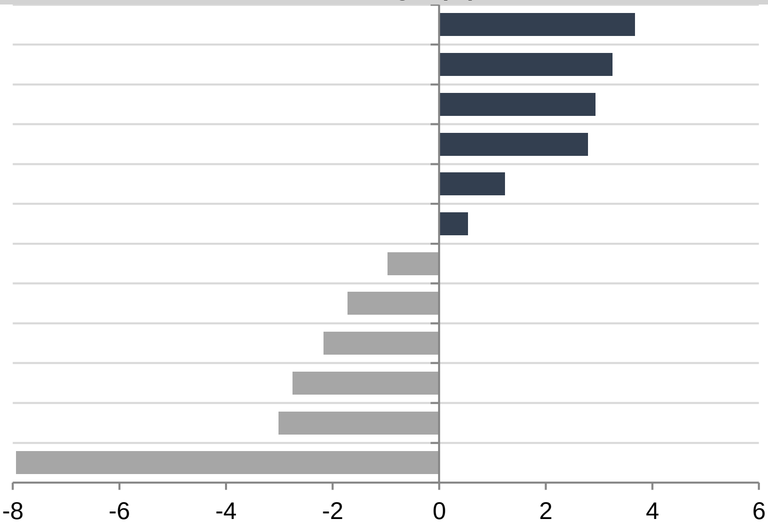
The high-levels of valuation dispersion that were observed last year have returned driven by ongoing increases in the valuations of stocks with defensive growth characteristics.  This group of stocks now trades at historically high valuation levels and the Fund remains underweight to this area.

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

### Asset Allocation

| Sector Weights | Fund (%) | Bench (%) |
|---|---|---|
| Materials ex Metals & Mining | 7.78 | 4.09 |
| Energy | 7.57 | 4.32 |
| Consumer Discretionary | 7.95 | 5.02 |
| Utilities | 5.00 | 2.21 |
| Industrials | 8.69 | 7.46 |
| Information Technology | 2.04 | 1.51 |
| Health Care | 6.01 | 6.98 |
| Consumer Staples | 5.68 | 7.40 |
| Financial ex Property Trusts | 34.12 | 36.28 |
| Telecommunications Services | 0.47 | 3.22 |
| Metals & Mining | 10.17 | 13.18 |
| Property Trusts | 0.39 | 8.33 |
| Cash | 4.13 | 0.00 |

Active Weight (%)




### Important Information

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