Ironbark Karara Australian Small Companies 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

PAT0002AU

ARSN

114 291 486

Fund Inception Date

30 June 2005

Manager Appointed

1 May 2010

Benchmark

S&P/ASX Small Ordinaries Accumulation Index

Distribution Frequency

Semi-Annually

Minimum Investment

$20,000

Fund Size

$668.9m

Exit Price

$3.8974

Number of Holdings

60

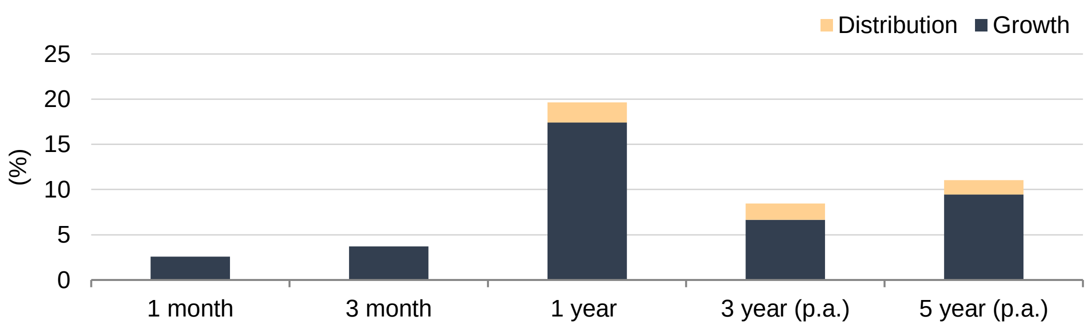
Market Review

Emerging markets underperformed in May while European equities fell on fears of political risk in Italy. The emerging market weakness continues a string of recent declines in Argentina (-22%) and Turkey (-4%), driven in part by the effect of the US dollar ('USD') strength on capital accounts dominated by US dollar-denominated debt, raising questions over the synchronicity of the global upswing. The S&P/ASX 300 Accumulation Index shrugged off concerns over populism in Italy and the potential for an EU breakup to rise 1.19% for the month, while the small company index gained 3.70%.

In Australia, May marked the release of the Federal Budget, which confirmed the government's commitment to lower corporate and income taxes and to increase infrastructure spending. Wage growth remained anaemic, rising only 0.5% in the quarter, the weakest print since 1997. Business indicators, however, continue to paint an upbeat picture with the NAB Business Conditions Index rising 6 to a new series high of 21. Regardless, first quarter capital expenditure rose 0.4% over the prior quarter, below expectations of a 1.0% increase. This moderated the year-on-year rise to 3.7%. More importantly, the second estimate of 2018/19 intentions was again below expectations at $87.7 billion, implying a yearly fall of 8%. March retail sales were flat, missing forecast expectations of 0.2% growth.

Amongst commodities, nickel prices climbed 11.5% in May, underpinned by strong demand, a global deficit and falling stockpiles. Weak nickel pig-iron production and strong stainless steel production have supported forecasts for a sustained deficit through the balance of the year. Coal prices also enjoyed a strong run, with thermal coal and met coal rising 11% and 6% respectively. Oil prices rose following the US decision to withdraw from the Iran nuclear deal, and then fell following reports Saudi Arabia and Russia are considering a 1 million barrel per day boost in order to offset shortfalls in Venezuela and Iran. Gold prices fell 2% on the back of a stronger US dollar.

Performance



	Net Fund Return (%)	Benchmark Return (%)	Active Return (%)
1 month	2.59	3.70	-1.11
3 month	3.70	4.11	-0.41
1 year	19.67	25.40	-5.73
3 year (p.a.)	8.46	11.55	-3.09
5 year (p.a.)	11.03	9.69	1.34
7 year (p.a.)	9.08	3.96	5.12
10 year (p.a.)	10.15	1.26	8.89
Since inception[1] (p.a.)	13.68	4.84	8.84

Past performance is not an indication of future performance. Net performance figures are calculated using exit prices, net of fees and reflect the annual reinvestment of distribution.

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

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Performance Review

The Ironbark Karara Australian Small Companies Fund (the 'Fund') returned 2.59% (net) for the month, underperforming the benchmark's return of 3.70% by 1.11%.

In May, the strongest contributors to Fund performance at a sector level were overweight positions in consumer staples, and metals & mining and underweight positions in telecommunication services and property trusts. An overweight position in information technology detracted.

At a stock level, positive contributors to monthly performance included overweight positions in Saracen Minerals, Hub24, Elders, and Bapcor. A nil holding in Metcash also added to performance. Shares in Saracen rose 14% after a market update noted that costs at the company's Carosue Dam operations are reducing as the Karari mine deepens driven by improving grade and width. The company is continuing to test Karari and Whirling dervish at depth targeting a ten-year reserve life outlook. Hub24 shares rose 24% on continued strong operating momentum with the market starting to look forward to the launch of white label opportunities in August and new features being added to the product offering. Elders shares gained 13% after the company reported a strong first half financial year 2018 result despite unfavourable seasonal conditions, driven by organic growth in its retail division where the company still has only a 16% market share and by acquisitions such as Titan Chemicals, a recent move to vertically integrate the broader Elders business. Bapcor shares rose 14% after reiterating full year guidance and providing further detail regarding the company's planned Asian expansion at a recent industry conference.

The largest detractors to monthly performance included overweight positions in Link Administration, Technology One and underweight positions in Reliance Worldwide, Wisetech Global and Whitehaven Coal. Link fell 17% after the Federal Government budget proposed consolidation of small and inactive superannuation accounts with the Australian Taxation Office to act as administrator. Link is the largest superannuation funds administration business in Australia and indicated that the unmitigated effect or "bear case" of the proposed changes would approximate 14% of earnings in the 2021 financial year. Technology One shares lost 13% after the company's first half year financial year 2018 result missed market expectations due to under-performance within the company's consulting division which is being restructured to focus on implementing the company's own software and weakness in the company's UK operations with the date for UK profitability now pushed back to 2020.

Top 5 Active Weights

Security Name	Sector	Active Weight (%)
Altium	Information Technology	5.25
Costa Group Holdings	Consumer Staples	3.91
Bega Cheese	Consumer Staples	3.47
Saracen Mineral Holdings	Materials	2.87
Elders	Consumer Staples	2.29

Key Contributors & Detractors over the month

Top 5 Contributors	Active Position
Metcash	Underweight
Saracen Mineral Holdings	Overweight
HUB24	Overweight
Elders	Overweight
Bapcor	Overweight

Top 5 Detractors	Active Position
Link Administration Holdings	Overweight
Reliance Worldwide Corporation	Underweight
Technology One	Overweight
Wisetech Global	Underweight
Whitehaven Coal	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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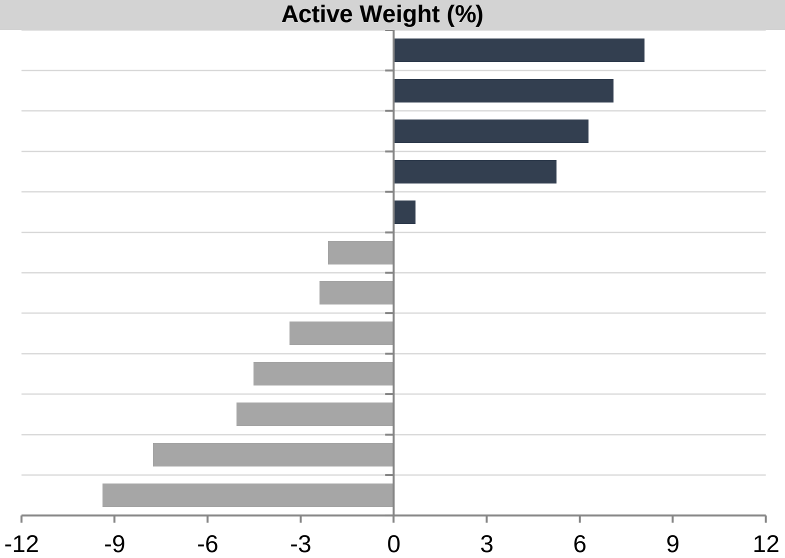
Asset Allocation

Sector Weights	Fund (%)	Bench (%)
Information Technology	16.58	8.49
Consumer Staples	15.75	8.66
Metals & Mining	22.76	16.49
Utilities	5.79	0.54
Financial ex Property Trusts	7.97	7.28
Telecommunications Services	0.59	2.69
Energy	5.50	7.89
Materials ex Metals & Mining	--	3.35
Health Care	2.01	6.53
Industrials	4.07	9.13
Property Trusts	2.83	10.58
Consumer Discretionary	8.98	18.37
Cash	7.17	0.00

Active Weight (%)



Important Information

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