Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

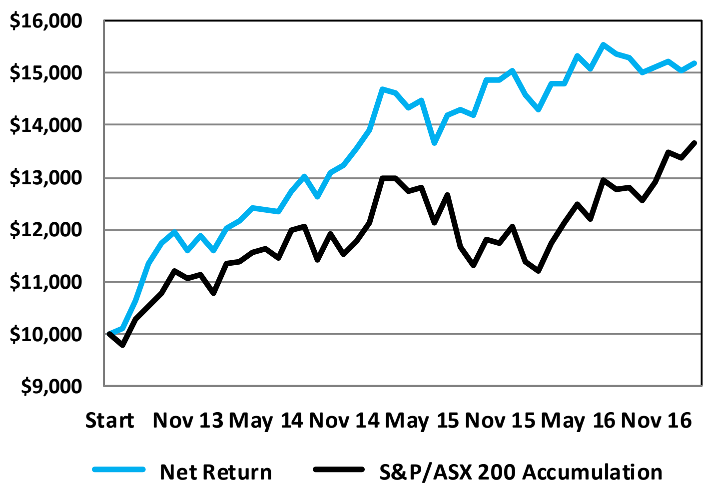
Fund Monthly February 2017

Return Summary

Period	1 mth	3 mth	6 mth	1 yr	3 yr (pa)	Cumulative	Per Annum
Fund Return	0.8%	0.5%	-1.3%	6.2%	8.1%	51.8%	11.8%
S&P/ASX200 Acc.	2.3%	5.9%	7.2%	22.1%	6.5%	36.8%	8.7%
Excess return	-1.4%	-5.4%	-8.5%	-15.9%	1.6%	15.0%	3.1%

Fund Returns are prepared on a mid unit price basis after management and performance fees inclusive of GST. Distributions are assumed to be re-invested at the mid unit price. Individual tax is not taken into account in deriving Fund Returns. In calculating the NTA, the Atlantic Pacific Australian Equity Fund ("Fund") asset values have been calculated using unaudited price and income estimates for the month being reported. Past performance is not indicative of future performance.

Cumulative Returns of $10,000



Fund Strategy

The Fund is a long-bias equity market product which typically buys or short sells Australian listed securities and derivatives. Net and Gross market exposure is maintained within a range of 0-100% and 0-200%, respectively.

The Investment manager employs their Quadruple Alpha Investment Strategy which focuses on outperforming over all market cycles by capturing upside returns while minimising downside risk.

The objective of the Fund is to outperform the benchmark by greater than 5% pa after fees over a 5-7 year time frame.

Market Overview - **The Australian equity market rose 2.25%** over the month of February 2017, underperforming the US market which rose 3.7%. As has been the case over the past 3-4 months, material outperformance has been in Financials and in particular the Banking sector due to rising long bond yields. The Banking sector rose over 4% in February, despite long yields being flat, reversing significantly the underperformance of last month with Westpac Banking (WBC, +6.3%) leading the way. **This now places Australian Banks again at peak valuations relative to the last 20 years (or should we say bubble-like valuations?)**. This is not surprising given it is estimated that Chinese investors are now buying 25% of new housing supply in NSW leading to very frothy housing prices (@ 12x average income is that sustainable?) which in turn underpins very little deterioration in credit costs as we saw during the month from the Australian Banks quarterly or half-yearly updates. And while this is a global phenomenon seen in other sought-after geographies, it remains astonishing that neither domestic macroprudential controls on credit nor foreign purchaser controls are having any impact in stabilising prices. Given the asymmetry occurring in China, i.e. **the flood gates of internalised capital are swamping other developed markets irrespective of quality or malfeasance**, arbitrary policy is unlikely to put a lid on domestic prices while there is an ongoing discount or equivalence compared to a foreign investor's home market. Either way, **it is going to end very badly** at some point despite our political masters wanting to kick the can further down the road. Indeed, not even regulators want to use the "B" word which in itself is very worrying. We know that in normal scenarios, **credit booms always end in busts**. For example,

every decade over the past 6 has had some example of a distressed asset scenario. Each scenario affects different asset classes ranging from equities, commercial property, residential property and others. Similarly, under the Chinese "pump-prime" scenario which the world has witnessed for many decades, we have seen prices in product markets significantly impacted but only through massive investment on a scale that has never been seen before in our lifetime ie the mining boom. But what it does highlight is that **when China does catch a cold, it won't just be resource demand** that will be impacted but the very underpinnings of our day-to-day lives given how far house prices have been propelled by this particular investor set. The Materials sector underperformed returning -3.2% over the month despite commodity prices remaining firm or positive. We were generally surprised with this outcome but nonetheless they are volatile earnings streams.

The Australian Company reporting season also took centre stage over the month of February. In general, apart from resource companies which showed significant earnings growth and in some cases material revisions to earnings, **upward revisions to earnings were quite muted** this time around. Relative outperformance of company shares, were in a number of cases, driven by capital management issues. In the case of Wesfarmers (WES), they have indicated a potential move to IPO their Officeworks business in addition to the trade sale of their coal business. This will provide the company significant cash flow which historically has led to cash returns or a sizeable share buyback, in total around 5% of their issued capital. In general, most businesses performed well with Bunnings now in a very strong competitive position with the recent demise of Masters. Coca-Cola Amatil (CCL) indicated they would buyback 5% of their shares over the coming year which led to outsized returns for shareholders. We are circumspect in general on their business and had it not been for the capital management initiatives, the share price would ordinarily have fallen. **Telstra (TLS) for which the Fund has had a short position** for some time now fell 3.6% over the month after delivering a weak result which in our view should have led to a more than 10% fall in their share price. Over time, we are convinced **the share price will have a 3 in front of it, not 4 or 5** due to the increasing competition they now face with the rollout of the NBN and the unlikelihood of them being able to replace the earnings they will lose without dilution to existing shareholders. We covered our position prior to the ex-date of their dividend and will await better levels to re-short.

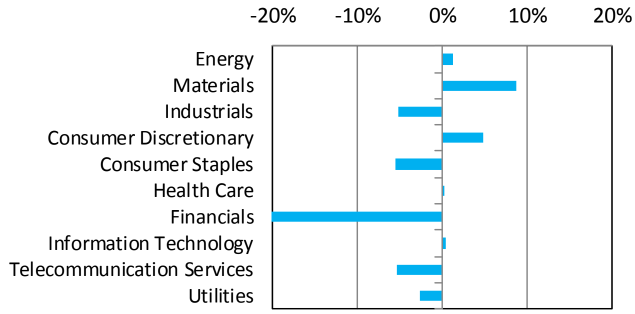
Given the lack of sizeable positive change in company earnings over the recent reporting season it is no wonder that the dispersion of returns or standard deviation of returns has been the lowest since inception of the Fund. But what was more surprising was the lack of conviction post result with most share prices selling off post result and not producing the "pop" which has been traditionally associated with a good report. Treasury Wine Estates (TWE) is a case in point. While the price rallied into the result, to see no material benefit over the month from what was a standout result with a 4% upgrade over forward estimates has been a little perplexing...On the day it was down almost 5%. **We always wonder whether we have missed something and whether the decision should be to liquidate** but on several reviews of the company's results we still failed to see why the price impact was so bearish. The price has subsequently recovered which we believe is the correct trajectory. **We weren't as lucky with JB Hi-fi (JBH)** which presents as one of the more peculiar price outcomes for this reporting season. The company reported upgrades of around 4% which on the day led to price performance of around 3%. Once again, the selling came in from the initial high point (+7%) on the day of the report. By the end of the month, the price was down 6% from levels prior to the report. This is certainly not the sort of volatility we expect from a relatively stable industry or at least no different to many of the industries we analyse. Notwithstanding, noise on the entrance of Amazon has taken the imagination of many investors with a concerted sell program being obvious. We don't believe the impact of Amazon is as dramatic as what is often hyped in the newspapers…more recently this has been hysterical. **We believe hysteria of this magnitude offers opportunity.** Similar hysterical price action has been seen in Ramsay Health Care (RHC) despite the company upgrading earnings by 2-4%. We were certainly not expecting an upgrade of this magnitude nor for the upgrade to be driven by the Australian business for which a sizeable competitor in the Australian market, Healthscope (HSO), showed continuing weakness. Even so, we were short into the event and because of this sell-on-fact behaviour we were able to cover our short. Nanosonics (NAN) was another company punished initially. However, the response range was closer to down 15% in a couple of days on no real news, i.e. they reported in line with positive guidance other than some Fund managers' view to treat it like a piñata! By end of month, prior levels were recovered. But perhaps **the most obvious price action of the month came from Ardent Leisure (AAD)** for which the Fund had a small short. When analysing this company historically, we have noticed the company does very well in the early stages of business development and then fails once these businesses start to mature. We have observed this in the Health Club business which they recently sold and from their recent report we have now observed this dynamic in their Main Event business, i.e. same-store-store sales are materially underperforming despite overall sales growing due to an overly aggressive rollout profile. In addition, the company has hyped their recent recovery in the Theme Parks business after seeing a dramatic fall in volumes with park closures post the recent fatalities in Queensland. Ordinarily, when one sees improving comparable sales growth percentages, one would presume there is a basing effect which translates to improved sales performance. But as we discovered at the time of each of the activity updates, when converted to actual sales the company was actually going backwards faster than expected. **This initial blind euphoria enabled us to short into the event** with both the deterioration in the Main Event and Theme Park businesses evidently not taken too well by investors. The company's share price dropped over 20% on the day after which we covered the Fund's short under $1.70.

Outlook - **We have now moved through the February reporting season with nothing much materially changing as far as earnings expectations are concerned.** Valuations for the market remain elevated across most sectors which in general may provide un-comfort for some investors. In an environment where earnings are not expected to move materially on average, the market is likely to remain in a tight range until expectations change for macroeconomic settings. This brings us to what has been happening more recently in the US which has previously provided a significant sentiment boost via expected reflation policies including a program of reducing taxes and infrastructure spending. However, once you delve into the detail some unexpected dynamics which we don't believe have been appreciated fully by the market could come to pass. For example, while it is not known whether the replace and repeal of Obama-care (RAROC) will occur, if we were to assume it does, this introduces a short contraction in fiscal budgets in the US which we don't believe are priced. Further, in the scenario where the RAROC does not occur due to political expediency, the failure of the current executive branch will not go unnoticed. Indeed, the prior austere Republican Congress could knock back any notion of pump-priming as per infrastructure spending on the basis of not wanting to extend the deficit ceiling as well as the economy improving of its own accord. Either way the uncertainty now evident from unexpected policy paths needs to be considered in the broader context of investment to which we remain alert.

Risk Statistics

	Fund		Index	
	3 Year	Inception	3 Year	Inception
Alpha (%pa)	1.6%	3.1%		
Downside Capture	53%	57%		
Standard Deviation	8.4%	9.1%	12.4%	12.0%
Sharp ratio	0.7	1.1	0.4	0.6
Sortino		1.8		1.3
Largest Drawdown	-7.1%	-7.1%	-13.7%	-13.7%

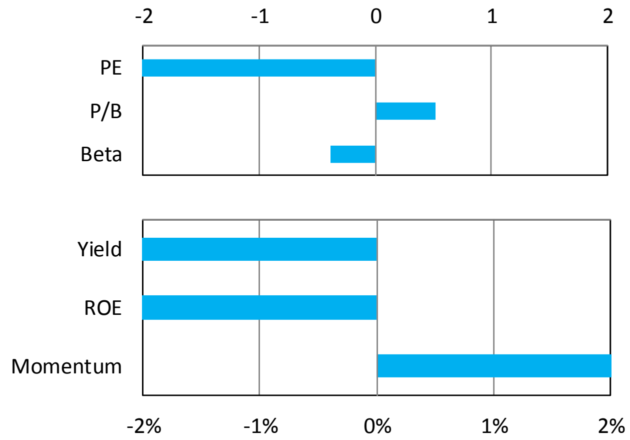
Sector Exposure



Exposure

	Long	Short	Net	Gross
Equity	84%	-24%	60%	107%
Index Futures			3%	3%
Net	84%	-24%	62%	110%
Cash			19%	

Factor Exposure



Contribution

Positive	Negative
ANZ Banking Group	Brambles
Ardent Leisure	Qantas Airways
Aristocrat Leisure	Retail Food Group
Challenger	South32

APSEC FUNDS MANAGEMENT

Fund Information

APIR Code	OMF0003AU	Responsible Entity	Equity Trustees Limited
Inception	1 June 2013	Investment Manager	APSEC Funds Management
Minimum Investment	$10,000	Administrator	FundBPO
Application/Redemption	Monthly	Custodian	FundBPO
Management Fee	2.0%	Prime Broker	Interactive Brokers LLC
Benchmark	S&P/ASX200 Accumulation	Auditor	PriceWaterhouseCoopers
Performance Fee	15% above S&P/ASX 200 Accumulation + 3%pa subject to a high water mark		
AUM of Fund	AUD$26.19m	Application Price	1.2948
Mid Unit Price	1.2935	Redemption Price	1.2922

Contact Information

Nicolas Bryon	n.bryon@apsec.com.au	Investment Manager	+ 612 8356 9356
George Paxton	g.paxton@apsec.com.au	Responsible Entity	1300 555 378
Website	www.apsecfm.com.au	Unit Registry	1300 133 451

Important information