# Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

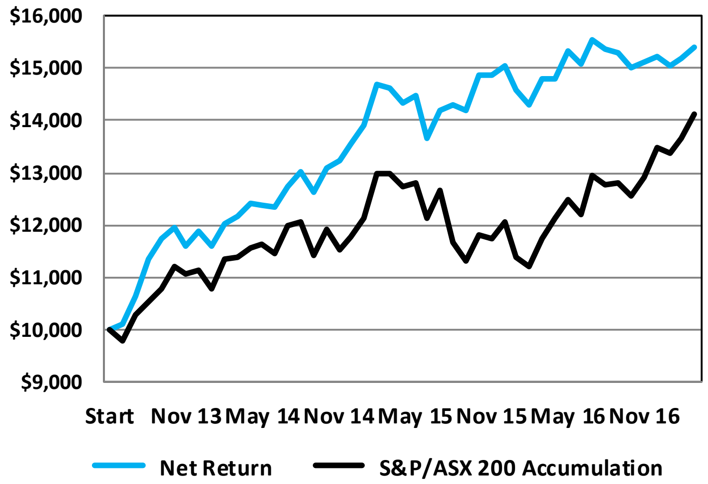
# Fund Monthly March 2017

## Return Summary

| Period | 1 mth | 3 mth | 6 mth | 1 yr | 3 yr (pa) | Cumulative | Per Annum |
|---|---|---|---|---|---|---|---|
| Fund Return | 1.4% | 1.2% | 0.7% | 4.2% | 8.1% | 54.0% | 11.9% |
| S&P/ASX200 Acc. | 3.3% | 4.8% | 10.2% | 20.5% | 7.5% | 41.3% | 9.4% |
| Excess return | -1.9% | -3.6% | -9.6% | -16.3% | 0.6% | 12.7% | 2.5% |

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

**Market Overview** - The Australian equity market rose 3.3% over the month of March 2017, outperforming most global markets. **We are not sure at a headline level why our market was so frothy** through the month particularly the vertical movement in the latter part of the month but nonetheless offshore investors are exerting their dominance via passive index fund flows not unlike the Australian property market. **Interest rate sensitive companies and offshore companies performed well** as long bond rates (as well as the AUD falling over the month) moved in line with US long bond rates - this has persisted into April 2017 and Australian 10y bond rates are now near pre-Trump levels. On the basis of strategy notes from well-known US analysts observed of late, it appears **the hype of Trump is now unfolding simply because of dysfunction**. This is particularly evident post the failure of any cohesion from the Republican Party to repeal and replace the Affordable Care Act in order to presage the fiscal policies touted during the election. It would now seem the timing of material fiscal policy changes is likely next year if at all. Therefore it is no surprise long bond yields have been falling to levels more akin to where the US Federal Reserve expects rates to traverse. **Peculiarly, Australian banks have continued to soar while global yields are falling** which is in contrast to the global banking sector which sold off over March 2017. One may argue recent increases of 20 odd basis points for mortgage products should reward investors but evidence to date has been **out-of-cycle increases have been a defensive move** rather than a tactical move to enhance profits - politically that would be very dangerous! Similarly, with global bonds falling are Australian banks likely to reduce mortgage rates now that the pressure of offshore rates is

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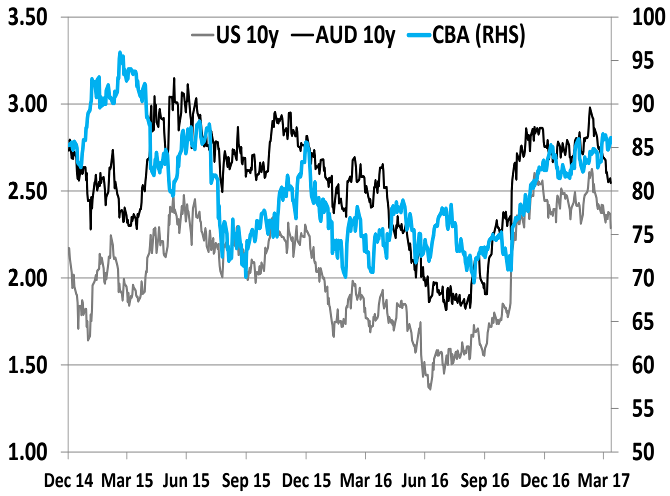
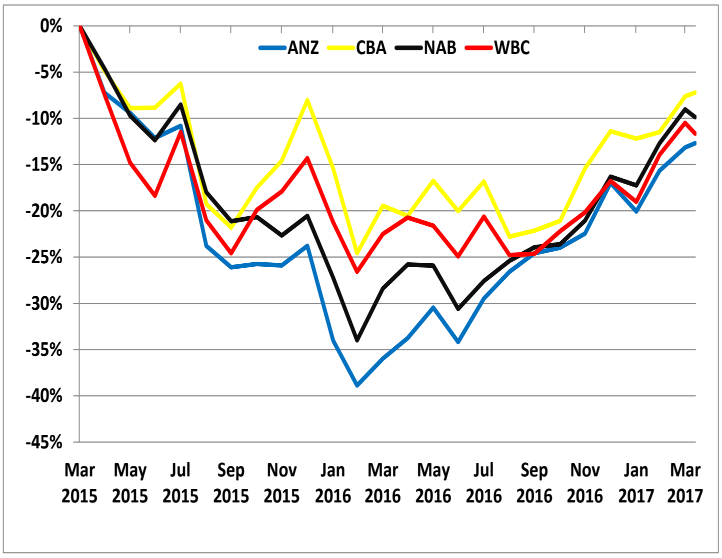
abating? Fanciful at best! Like commodity companies which rally on underlying commodity prices, banks have similarly rallied/fallen when long bonds yields have risen/fallen. If we review the chart on the right, which compares the share price of the Commonwealth Bank of Australia (a proxy for the entire Australian Banking sector; CBA; Blue) with Australian 10y bond yields (black) and US 10y bond yields (grey), **we can see a stark correlation- rising bank shares with rising long bond yields and vice versa.** However, this has significantly decoupled this month with Australian bank share prices remaining firm despite long bond yields falling almost 20%. From a strategy point of view, the Australian banks should move now to capitalise their balance sheets above a level of reasonable doubt before prices revert from all time high valuations. In the chart below, **Australian banks are still around 10% below their previous peak** (inclusive of dividends). Some analysts have reasoned a further AUD$20b is required to provide the necessary buffer accounting for ~1.5% of the Australian market's capitalisation - easily consumed in a world of excess liquidity. This is probably even more relevant given the growth in interest-only loans which now account for around 40% of the industry's loan book. With these types of loans, there is essentially no protection with respect to falling prices as there is very little capital to absorb losses as they are structured as a tax shield. The 2015 to 2017 vintage of loans has been accompanied by acceleration in the composition of total loans towards interest-only loans in tandem with accelerating house prices which are likely to be a harbinger of hard times to come for the Australian Banks.




**Fund performance was dominated by continued positive trajectories** in a number of key companies we have owned for some time now with further confirmation post the recent reporting season. **Challenger Financial Group (CGF) has continued to move upwards** with very little variation day to day - ordinarily this is a positive attribute of a stock price. We haven't tinkered with this position for quite some time but looking at valuations the price appears to be fully valued. This is no different to the rest of the market. We await further concrete evidence (eg quarterly sales updates) to ensure their long duration annuity strategy does not lead to higher capital requirements. **South32 (S32) also retraced strongly over the month after a disappointing February where it fell 10% on no particular news.** The recent update by the company shows how strong the cash flows have been and are now looking to implement a 5% buyback. If prices remain firm over coming years this could well be a cash bonanza for shareholders. CSR (CSR) rebounded from a weak February for no particular reason. **CSR are in a similar situation to S32 whereby excess cash is building leading to enormous buy-back potential.** In the case of CSR, further large scale buybacks could be a feature of future updates. The company has had an unusual "conglomerate" structure with seemingly unrelated businesses. This is certainly the case for their Aluminium smelter near Newcastle, NSW. This has always been a curious fit for the company and has at times been deadweight on their share price. However, of late, with aluminium prices being the strongest they have been for many years finally the share price is starting to reflect the true value of their businesses. A sell down of this asset might well be prudent at this stage of the cycle which could lead to a very large return of capital - we aren't betting on this but it would be a nice surprise. QBE Insurance (QBE) also recovered from the prior month's lows. **QBE's stock price has perhaps been the most frustrating of all over the past 6 months** since the US Federal Reserve's move to raise the cash rate and the "trump-bump" which was seen to further drive long bonds higher as the price has gone sideways. QBE, from our analytical framework and understanding, is expected to be one of the most sensitive companies to rising long bonds and to see no material price increase compared to other similar assets (eg Australian Banks) with very little sensitivity to rising long bonds is a little perplexing. Nonetheless, we remain positive on the future fundamentals of the company and expect a re-pricing over the coming year. By far and away the **largest contributor to returns was our long position in Mesoblast (MSB)**. We don't generally hold much of the stock but have been in an out of the stock over the past 18 months as prices have hit rock bottom. After various equity raisings to support the longer term development of their product pipeline together with very promising Phase 3 trial data, the historical worry by investors of perpetual capital raisings appears to be over. We have generally reduced the position into the strength of the share price but hold a core position. We remain positively disposed over the coming years and will remain holders over the long term. **We also accumulated a position in Ramsay Healthcare** (RHC) during the severe downdraft in the share price. We view this as highly irrational investor behaviour and also wonder at why investors dump a stock because a key executive decides to leave. For a company of this calibre (eg Tier 1 private hospital assets in various jurisdictions), they will always attract high quality staff no different to say the transition CSL Limited made. So when we see the price of such high quality assets reverting downward so strongly and for no discernible reason we take action. **The only mistake was that we didn't acquire enough.**

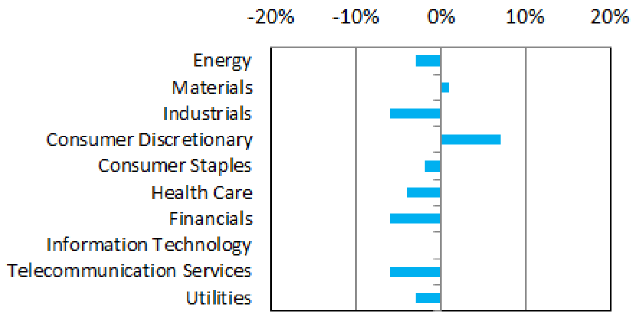
## Outlook –

As we mentioned last month, **the uncertain policy paths** we now witness globally will remain a feature of the investment landscape for the foreseeable future. With no real progress made by the Trump administration and with US-led military events now becoming normal, we as investors need to be on our toes for markets will not be compromising when it comes to the potential to wipe out large parts of humanity - we hope this is not the outcome that transpires anytime soon. Within our own borders the cyclical upswing that has been associated with the east coast housing boom will come to an end over the coming years. The much touted structural shortage of housing on the east coast will no longer be evident once cyclical construction employment attempts to find work elsewhere. **This is no different to the massive construction boom that was once viewed as a marvellous outcome for the Western Australian economy** during the mining boom to now being viewed as a pariah state with economic activity weak and getting weaker and house prices in some case falling over 50%...**an ominous sign for the East coast with more certainty than many people will accept.**

## Risk Statistics

| | Fund | | Index | |
|---|---|---|---|---|
| | 3 Year | Inception | 3 Year | Inception |
| Alpha (%pa) | 0.6% | 2.5% | | |
| Downside Capture | 53% | 57% | | |
| Standard Deviation | 8.2% | 9.0% | 12.3% | 11.9% |
| Sharp ratio | 0.8 | 1.1 | 0.5 | 0.6 |
| Sortino | | 1.9 | | 1.4 |
| Largest Drawdown | -7.1% | -7.1% | -13.7% | -13.7% |

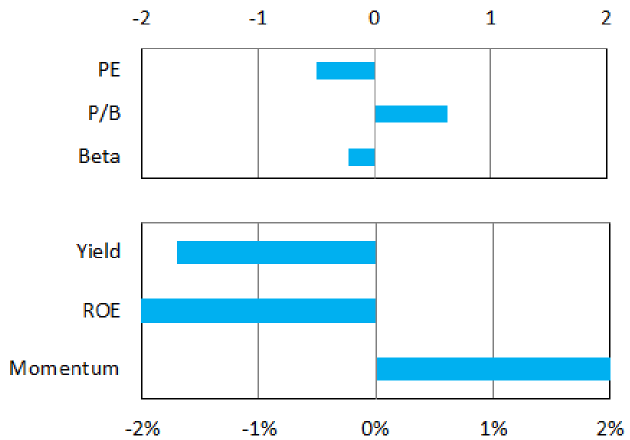
## Sector Exposure




## Exposure

| | Long | Short | Net | Gross |
|---|---|---|---|---|
| Equity | 88% | -6% | 82% | 94% |
| Index Futures | | | 0% | 0% |
| Net | 88% | -6% | 82% | 94% |
| Cash | | | 18% | |

## Factor Exposure




## Contribution

| Positive | Negative |
|---|---|
| Challenger | JB Hifi |
| CSR | Norwood Systems |
| Mesoblast | Rio Tinto |
| South32 | Woodside Petroleum |

# 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

| | | | |
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