

Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

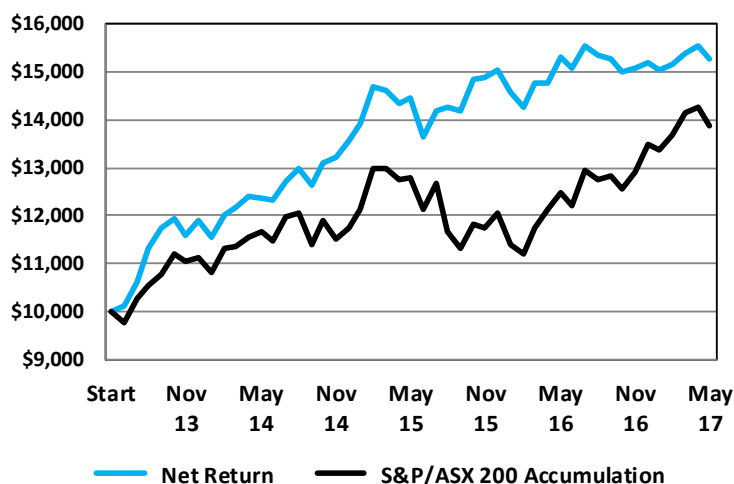
Fund Monthly May 2017

Return Summary

Period	1 mth	3 mth	6 mth	1 yr	3 yr (pa)	Cumulative	Per Annum
Fund Return	-1.8%	0.7%	1.1%	-0.3%	7.3%	52.7%	11.2%
S&P/ASX200 Acc.	-2.8%	1.5%	7.5%	11.1%	6.0%	38.8%	8.5%
Excess return	1.0%	-0.9%	-6.3%	-11.4%	1.3%	13.8%	2.6%

Fund Returns are prepared on a redemption 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.

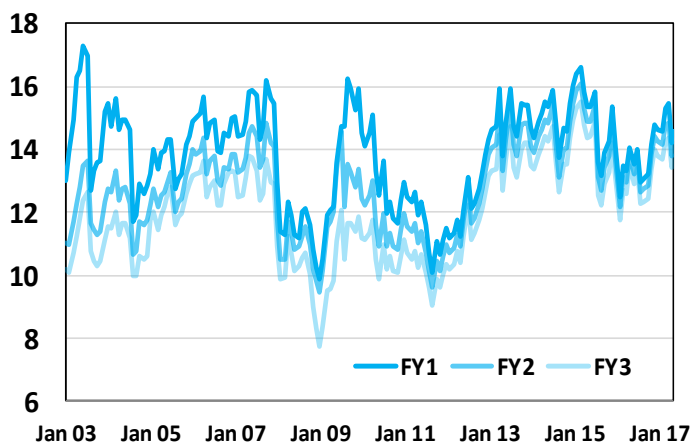
The Investment manager employs their Quadruple Alpha Investment Strategy which focuses on outperforming over all market cycles by capturing upside returns while minimising downside risk.

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 fell 2.8% over the month of May 2017, with Australian banks finally reverting from lofty valuations. In ANZ's case, it fell over 12% (inclusive of dividends) over the month – this is a huge retracement against what appeared to be blind-buying by market participants (eg buying by passive index funds including ETFs) over recent times. Fundamentals eventually took hold with the recent Bank reporting season confirming a lack of quality growth over coming years. This is against a backdrop of East Coast cyclical construction activity nearing its peak with the expected oversupply conditions in Australian property to take hold and start to feature in the credit metrics of the Banks. The Banking sector has been further lacerated over the month by various regulatory changes introduced via the recent budget updates from various Australian Government agencies. In the case of the Federal Government, they have introduced a "bank-tax" which will lead to certain negative growth projections across the banking sector not to mention the near certainty of falling dividends over coming years. While the banks will attempt to cost-recover part of the impost of the tax through serendipitous out-of-cycle housing loan rate rises, business and SME loan rates, fees and charges, total recovery is very unlikely. There is a certain amount of deja-vu with the current Federal Government introducing a tax at the top of the property construction cycle, just as the Rudd Labour Government attempted to implement a mining tax at the peak of the mining construction cycle. Further compounding the sector, the NSW Government (and in other ways in Victoria) has implemented a doubling of stamp duty for foreign investors from 4% to 8%. As we have argued in past reports, these demand

side measures will behave like the natural reversal of house prices in the mining states due to the exodus of cyclical employment (proxy for housing demand) associated with the end of the mining construction phase. With East Coast governments now reacting late in the piece, these measures will have a disproportionate impact by targeting one of the largest buyer cohorts. This is too little and too late in our view with estimates of additional government revenue likely to fall short as these buyers reduce their interest in Australian property significantly as they have in other regions of the world. In any case, downward pricing pressure on East Coast property prices is coming due to the exodus of cyclical property construction employment as well as demand-side regulatory tinkering. It surprises us that infrastructure spending is not accelerating to replace property employment albeit it could never replace this most important sector.

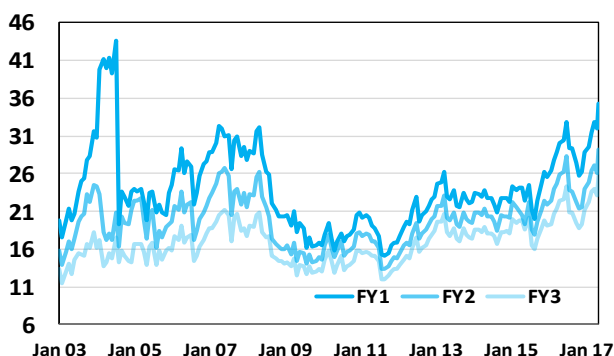
CBA - Forward PE Valuation



the valuation range is around 15x and the low is around 10x. This chart covers many structural episodes in bank earnings including the pre-GFC credit boom (<2008), post GFC re-capitalisation, return to growth and a credit boom as of now. Even so, the range has been preserved and is likely to provide a road map for future valuation of a typical bank in Australia. This reasoning we believe applies to other sectors as well.

In the case of CSL, which has had its fair share of issues over the past couple of years with earnings downgrades leading to flat earnings trajectories and the obligatory hockey-stick forecasts of analysts showing an enormous growth trajectory (in part due to the trajectory of their influenza business), [one must wonder what is baked into forecasts](#) and are they attainable (as per the EPS revision chart to the right). If the company doesn't meet a lofty >20% earnings growth outcome in FY18, then clearly the company's share price will come under pressure. In the case of CSL, one must be comfortable with

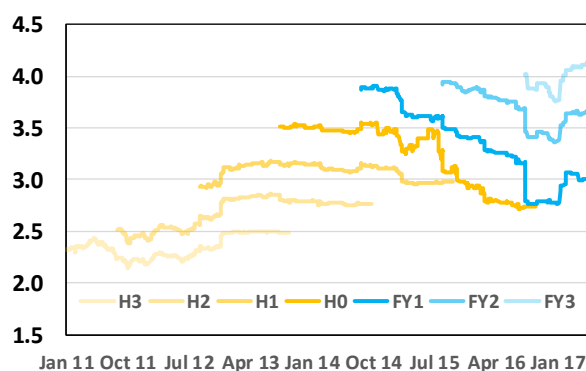
CSL - Forward PE Valuation



even maintaining a long-term position in an investment like this.

Outside of the Banking sector issues above, which will have far reaching impacts over coming years, the other main issue confronting us relates to valuation or a [lack of valuation support](#). This is an important consideration as we must, as all active investors should, [remain disciplined to our core beliefs](#) and remain invested only where valuation makes sense. While ordinarily valuation has very little impact on the performance of individual securities, [valuations do matter when they are at extremes](#). We have long believed that a company's valuation (or intra-sector) will have a range. Very [rarely do valuations subsequently jump out of historical ranges](#). If one reviews the forward Price Earnings (PE) ratios of Commonwealth Bank (CBA), the top of the

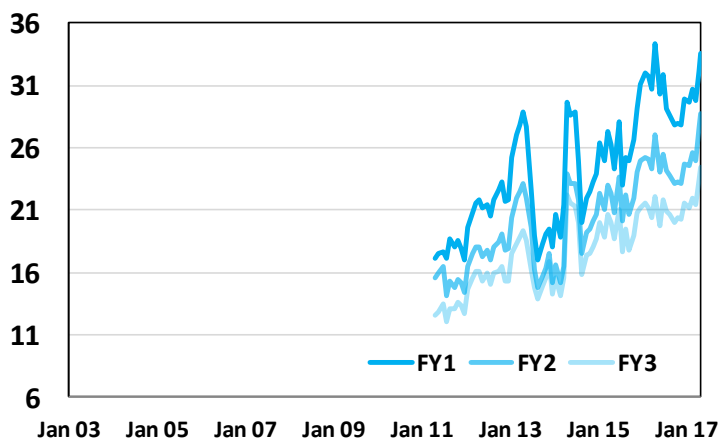
CSL - EPS Revisions



valuation to invest in the company's shares. In the chart to the left, the [valuation of the company is nearing the highs of previous exuberance](#). If we use the corollary above with respect to CBA, then it is probably the case that CSL from a valuation point of view will peak around these levels as it has done over long periods of time. And while earnings expectations have been pumped up recently any return to a downgrade cycle will leave the share price vulnerable. [CSL presents as an asymmetric payoff](#) to our way of thinking i.e. all the upside appears to be priced in and it would be difficult to justify buying or

CSL is not alone in terms of the collection of companies now exhibiting extreme valuations. There are numerous top 100 companies ([we count over 30 companies](#)) that have reached extreme valuations or more appropriately, are now priced for perfection. This is a dangerous environment as fundamentals are clearly pointing the other way for several

TWE - Forward PE Valuation



companies. Considering this valuation discipline, we have chosen to liquidate our long-term position in Treasury Wine Estates (TWE) simply because the growth expectations and valuation are too high. On review of TWE's valuation (to the left) and potential earnings trajectory (high teens growth for many years), [we are not sure one can justify the recent price discovery](#) in the company's shares. While we had been quite bullish on the pricing of wine into China (whom have lifted premium wine globally much the same way they have lifted many other prices), given there is very little visibility on pricing or volumes compared to other markets (eg Iron Ore, Copper), we have taken the tactical view of waiting for

the company to report in August. With 60%+ growth expected leading into the August report, we are mindful that any miss will not be taken well by the market. Other activity included a tactical Buy into Westfield (WFD). We have seen time and time again, where some institutional investor decides they want out and subsequently dumps share inventory on the market. We have seen this recently in Ramsay Health Care (RHC) which we spoke of in March 2017. On each occasion, [we have taken the opposite view as there was no fundamental reason for price underperformance](#) but merely specific flow. We use various indicators to assess the optimal point in time to gain exposure and we especially like situations where the selling appears exhaustive...it may seem scary to the ordinary investor the situations where the rate of change in prices is accelerating but [we will always take a contrarian view where price action is not justified by fundamentals](#). In the case of WFD, we bought @ \$8.27. Considering the recent low was \$8.23, these were remarkable prices. We also took the opportunity to gain exposure in Challenger Financial again after selling out of the Fund's position @ \$13.40. We bought most of the position back around \$12.50. We are mindful of valuations, as of late sales traction in their longer duration annuity products has plateaued. We also chose to sell out of the Fund's position in Seek (SEK). Recently they had indicated a sell down of their Chinese employment business which on our review was grossly undervalued. This caused initial euphoria on the day of the transaction in February 2017 and over April and May 2017 the price has rallied from below \$15 to over \$18. We have no idea as to why the shares have rallied so dramatically (i.e. no fundamental justification) as over this time nothing has changed. We took the opportunity to sell out the position around \$18.30 as the stock had moved into a heavily overbought state.

Outlook – After a horrible May 2017 for the market (down 2.7%), [we are remaining patient and on the sidelines waiting to pick up cheap companies into tax-loss selling](#) through June 2017. This is an environment which never ceases to amaze us from year to year. Retail companies have borne the brunt of a lot of selling due to [Amazon-induced hysteria](#) and this may be a segment we chose to look at leading into the end of the financial year. There are numerous companies that are so far removed from or too small for the Amazon distribution channel, which are now presenting as good value. Similarly, well run mid to small caps are now looking very good value with prices having fallen considerably due to the exodus out of small caps into large caps...[once again a flow argument which will reverse at some point](#). Tactically, tax loss selling provides the extra impetus for buying underperforming quality companies. And while a recovery across the globe is expected, we are also mindful given recent activity data that expectations may not materialise. This is perhaps more acute than most have expected considering firming oil production has been baked into these forecasts. [Downgrades to US manufacturing production is likely](#) to be the next pillar of weakness to US GDP growth not to mention falling inflation expectations as US shale oil production returns to their slumber.

Risk Statistics

	Fund		Index	
	3 Year	Inception	3 Year	Inception
Alpha (%pa)	1.3%	2.6%		
Downside Capture	54%	58%		
Standard Deviation	8.3%	8.9%	12.4%	11.8%
Sharp ratio	0.7	1.0	0.4	0.6
Sortino		1.7		1.3
Largest Drawdown	-7.1%	-7.1%	-13.7%	-13.7%

Exposure

	Long	Short	Net	Gross
Equity	51%	-9%	42%	59%
Index Futures			0%	0%
Net	51%	-9%	42%	59%
Cash			58%	

Contribution

Positive	Negative
Boral	G8 Education
Challenger	Norwood Systems
Magellan Financial	Mesoblast
Treasury Wine Estates	Vocus Group

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	1.2938
Mid Unit Price	1.2925	Redemption Price	1.2912

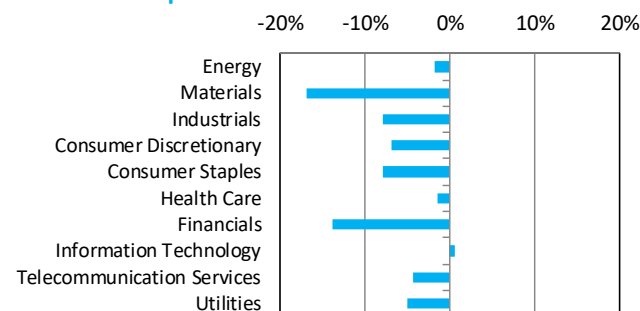
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Sector Exposure



Factor Exposure

