Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

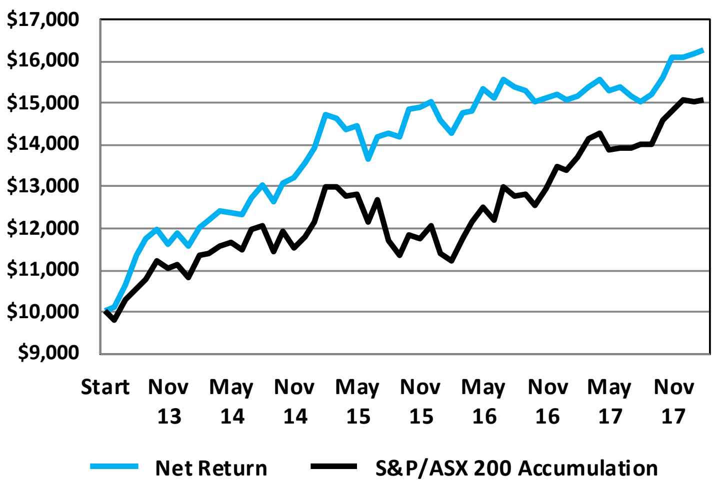
Fund Monthly February 2018

Return Summary

Period	1 mth	3 mth	6 mth	1 yr	3 yr (pa)	Cumulative	Per Annum
Fund Return	0.7%	1.3%	8.3%	7.3%	3.5%	62.7%	10.8%
S&P/ASX200 Acc.	0.4%	1.7%	7.5%	10.1%	5.1%	50.6%	9.0%
Excess return	0.4%	-0.4%	0.8%	-2.8%	-1.6%	12.1%	1.8%

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.

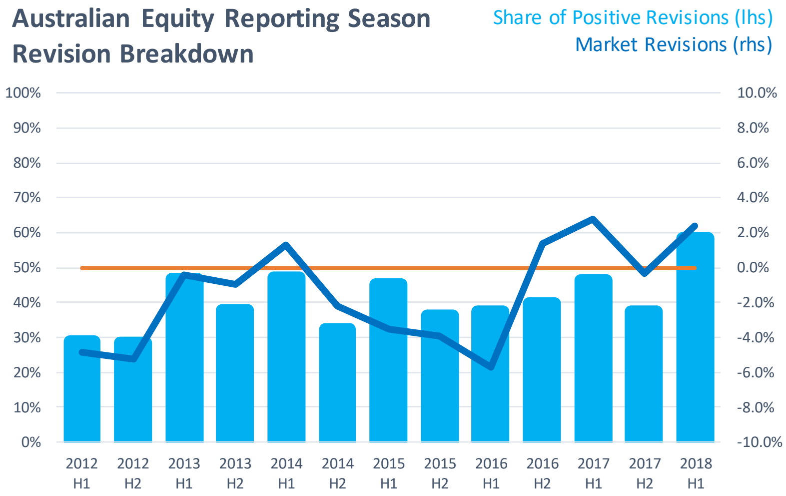
The Investment manager employs their Quadruple Alpha Investment Strategy which focuses on outperforming over all market cycles by capturing upside returns while minimising downside risk.

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 ended the month up 0.36% after recovering from being down over 3.5%. This was a remarkable achievement with the wobbles in other global markets not evident in Australia on a month end basis. The S&P500 fell 3.9%, a similar magnitude to the Nikkei which fell 3%, as 10-year bond yields rose and almost broke the 3% barrier, a level not seen since late 2013. This lead to a few calamitous days on markets with the S&P500 down over 10% at one point. It too recovered 7% from these levels. But what caused this bout of volatility? While some mean reversion from the prior month's rally of over 5% for the S&P500 could explain part of the move, it was the consecutive rise in wages that brought the inflation genie out of the bottle temporarily. Temporarily is a good word as the latest reading in early March 2018 has shown the potential pressure from rising wage costs feeding into inflation a mirage. We had contended that wages are unlikely to accelerate in the short term and the data has confirmed this. Outside of short term transitory effects from a reduction in tax rates which benefit very little the working class of America, there remains too much slack in the participation rate (of those seeking work) to herald a new paradigm in wages growth. But that's not to say long bond rates will not continue to rise, they will but at a slower rate than many expect. The month of February was also dominated by talk of "trade wars" with the introduction of tariffs on Steel and Aluminium imports into the US. We remain sceptical of the benefit of protection particularly as the US administration appears to be using an incomprehensible argument regarding current account deficits as well as relying on a measure which attempts to quantity the disadvantage of US goods entering another country which includes local economy consumption taxes (in the case of Europe Value-added taxes). This is mind-boggling arithmetic. In any case, so long as the extent of protection doesn't move too aggressively we suspect markets will continue to shrug off these "theatrical" performances.

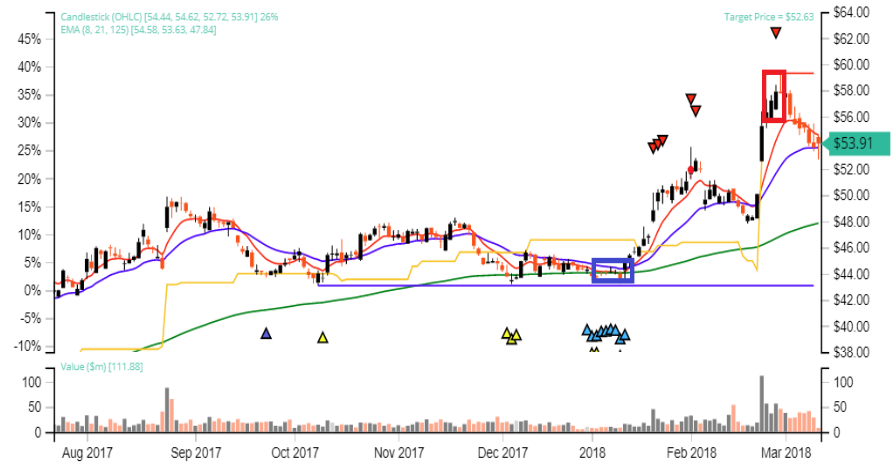
Notwithstanding offshore calamities, the Australian Reporting season was one of the better performances. As per the graphic below, it shows that the share of positive EPS revisions (3-month changes relative to the end of the reporting season) moved above 50% for the first time in over 6 years. At a market level, revisions over the reporting season were positive reinforcing trends over the past 2 years. Offsetting this to some extent was Commonwealth Bank (CBA) which saw negative revisions of close to 5% due to increasing compliance costs which are unlikely to abate for the foreseeable future. The resource sector was generally downgraded post reporting with cost profiles surprising on the downside. We had made mention of the peculiar, contrived price lifting of BHP over late December and early January 2018 in a prior report - subsequent price behaviour reflects the unwinding of this exuberance with the EPS trajectory trimmed by 5%. Within the most liquid companies, the A2 Milk Company (A2M) was the standout with EPS revisions of over 20%. You don't see these magnitudes very often and just when we thought it couldn't get any better for the company, it just did with a strategic supply agreement with Fonterra (who appear to be quite happy to chase the fortunes or otherwise of all Australian infant formula companies). The speed at which A2M has morphed from an emerging milk alternative to a tasty infant formula company is nothing short of spectacular. Investors have been rewarded with a 30% increase in the share price.

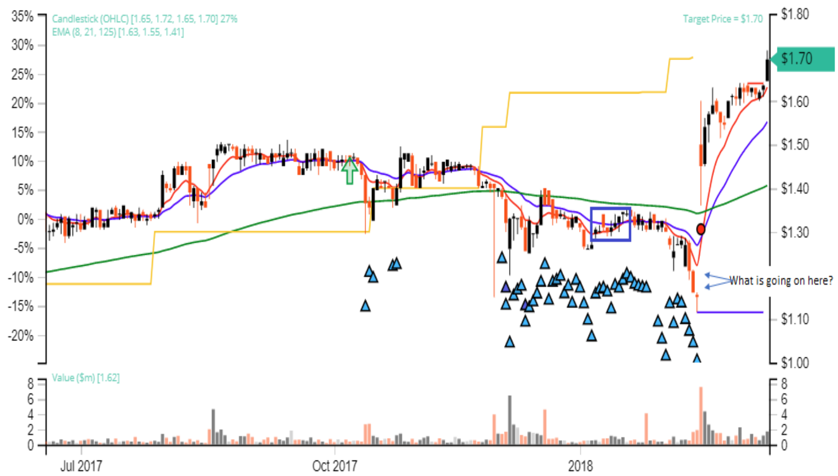


In terms of Fund performance over the month, we too had some good outcomes from the reporting season and large downdrafts were generally absent. On the negative side, our position in Invocare (IVC) was impaired with guidance leading to out-year downgrades contrary to our expectations. We chose to liquidate given valuations are not generally supportive for low growth. Similarly, Ramsay Healthcare (RHC) fell post result. We have chosen to remain in the position as the company has not genuinely seen significant deterioration in earnings, testament to the stable industry structure they participate in.

On the positive side, we had several significant outperformers. In each case, our accumulation was initiated via the HALO software. In particular, we made various investments across a number of sectors in the lead up to each company's reporting period during prior months. For example, our investment in the travel industry led to outsized gains. In the case of Corporate Travel (CTD) we accumulated in early December 2017 around \$20.30 and topped up around \$20.10 in early February as shown in the chart to the left. The company provided positive guidance with both organic and acquisition led growth supporting growth expectations. We chose to trim the position towards the end of the month achieving prices around \$25.60 on average. Flight Centre (FLT) was another company we had entered in anticipation of strong earnings outcomes. FLT has been somewhat of a less-than-successful experience for us over the life of the Fund. In most instances, we have exited after a poor report to only then find that other investors were quite happy to feed on our scraps. However, this

time we were on the right side of the ledger with price performance accumulated over both January and February. As can be seen from the chart to the right, our entry into the stock was as optimal as it could get in the short run with prices around $44.10. Post a positive report we have trimmed the position achieving prices around $57.10. The signals that we have implemented for both buying (structural longs) and selling (short term tactical reduction in exposure) have led to very precise and on the surface optimal outcomes. Both Corporate Travel and Flight Centre provide very good indications on how we allocate capital in the short run and will be a feature in years to come. To reinforce this message once more, we also accumulated exposure in Costa Group (CGC). This again was signalled based on confirmatory trends across earnings and price with a short term sell down initiated via an institutional investor as shown in the chart below. The initial interest in the company came about due to a very large spike down on the 6th February 2018. Often spikes like these are accompanied by some company news. But given the behaviour of the candle, it became apparent that the price movement could only be explained by a large institution selling down. Peculiarly on that day, a "cease to be substantial shareholder" notice came out which was preceded by a sizeable on-open sell order causing a large price move. Of note is that this notice referred to a short-sellers borrowed position, and thus it showed someone who had been short was covering their short i.e. there should have been buy pressure and not the sell pressure we had seen. We had been positively disposed to the company from a fundamental perspective for quite some time but were hesitant to enter given how strong the share price had moved over the preceding 6-12 months. However, on closer inspection with the expectation of further upgrades likely due to a lack of weather events in the first half and continuing growth through acquisition, we accumulated a position around $5.77. Once again, short term tactical indicators led us to trim the position waiting for better prices at some point in the future. There were a few other examples which followed a similar storyline over the reporting season. One case where we needed to hold onto our view despite the price reacting perversely was in Service Stream (SSM) as shown in the chat to the right. This was a smaller position due to general liquidity. In the lead up to the report, the company's share price moved perversely and what amounted to no discernible reason. Obviously, when prices move contrary to what one expects, you must always re-assess. We searched high and low for apparent reasons. None came to mind with any real conviction with potential NBN concerns over done. Prior to the report, we found the position underwater to the tune of 20c after having picked up the position around $1.30. And the rest is history. Post report we have decided to continue holding as valuations are supportive.





Outlook – After what appears to be a productive reporting season, we have an accumulation bias waiting for prices to revert to reasonable levels. As we noted last month, now is not the time to be chasing high prices. We generally have not been one to chase a trend and while this has cost us in relative performance from time-to-time, we believe the discipline of waiting for prices will be far more important over longer periods of time. Indeed, the mere existence of volatility now returning to global equity markets is food for thought and should be embraced. This is driven on numerous fronts including:

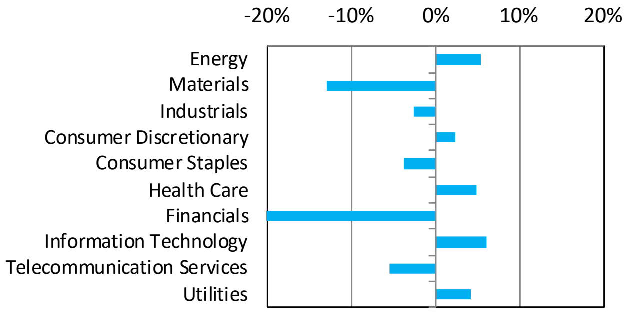
1. Inflation uncertainty - does this lead to higher bond price premiums?
2. Trade wars - is retaliation nigh?
3. Political uncertainty - has the political "right" ran too hard or is it a sign of things to come over multi-decades?
4. Higher longer duration bond prices - what impact will higher interest rate have on the global housing bubble which has been fed off ultra-low rates for an extended period? and;
5. Domestically, what happens after the infrastructure boom?

Encompassing all potential ideas and not limited by the list above, we remain vigilant and will continue to seek optimal risk-adjusted returns unlike the market. With all the exuberance that we see day to day in the media what struck us of late was how poor returns in Australia have been for the past three years. Historically, returns of close to 9-10% were seen as normal. But over the past 3 years in Australia, returns have been closer to half that measure. This too should be food for thought.

Risk Statistics

	Fund		Index	
	3 Year	Inception	3 Year	Inception
Alpha (%pa)	-1.6%	1.8%		
Downside Capture	60%	58%		
Standard Deviation	7.8%	8.4%	11.3%	11.0%
Sharp ratio	1.0	0.1	0.7	0.1
Sortino		1.3		1.3
Largest Drawdown	-7.1%	-7.1%	-13.7%	-13.7%

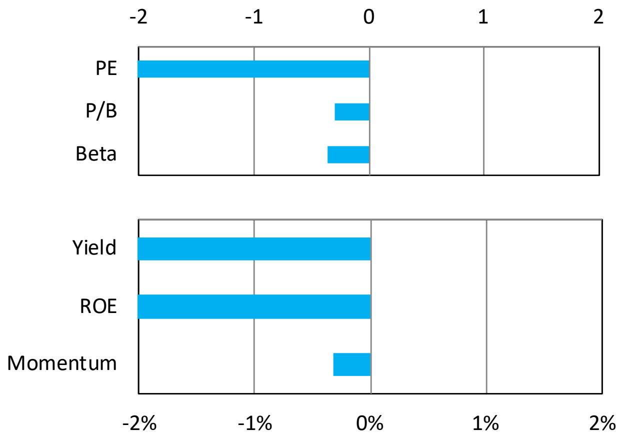
Sector Exposure



Exposure

	Long	Short	Net	Gross
Equity	76%	0%	76%	76%
Index Futures		-1%	-1%	1%
Net	76%	-1%	75%	77%
Cash			25%	

Factor Exposure



Contribution

Positive	Negative
Corporate Travel	Go2 People
Costa Group	Norwood Sysmtems
Flight Centre	Ramsay Healthcare
Mesoblast	Sydney Airports

Fund Information

APIR Code	OMF0003AU	Responsible Entity	Equity Trustees Limited
Inception	1 June 2013	Investment Manager	APSEC Funds Management
Minimum Investment	$10,000	Administrator	Mainstream Group Holdings Ltd
Application/Redemption	Monthly	Custodian	Mainstream Group Holdings Ltd
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		
Mid Unit Price	1.2800	Application Price	1.2813
		Redemption Price	1.2787

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Important information