Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

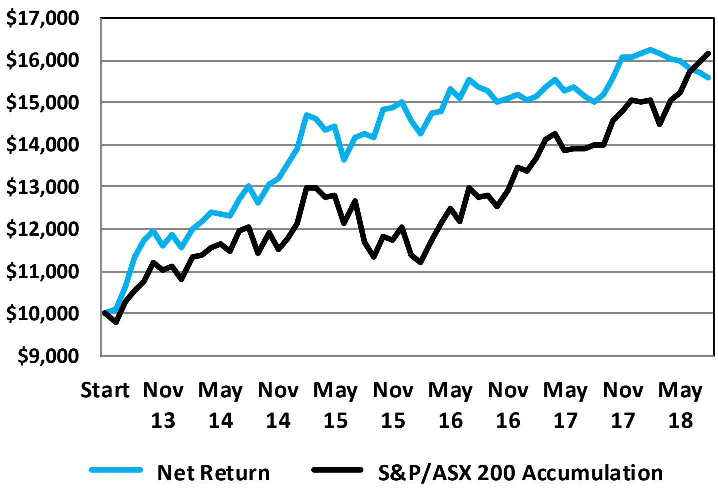
Fund Monthly August 2018

Return Summary

Period	1 mth	3 mth	6 mth	1 yr	3 yr (pa)	Cumulative	Per Annum
Fund Return	-0.81%	-2.5%	-4.3%	3.7%	2.9%	55.8%	8.8%
S&P/ASX200 Acc.	1.42%	6.2%	7.3%	15.4%	11.5%	61.6%	9.6%
Excess return	-2.23%	-8.6%	-11.6%	-11.7%	-8.5%	-5.8%	-0.8%

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

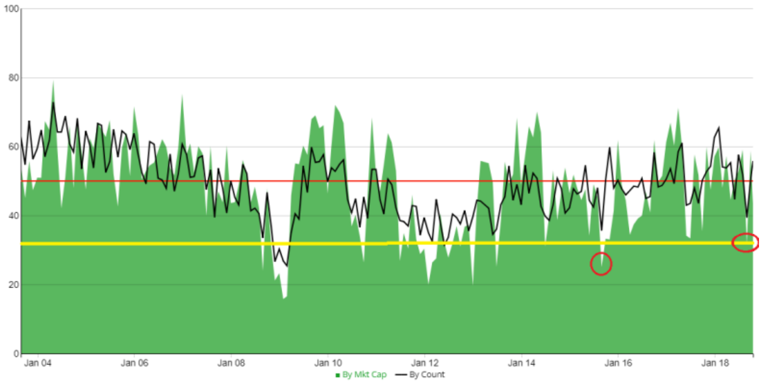
The objective of the Fund is to outperform the benchmark by greater than 5% pa after fees over a 5-7 year time frame.

Market Overview

The Australian equity market continued is positive running streak ending the month up 1.42% as market participants continued to buy through the reporting season. As we have noted in the past, valuations have been looking quite stretched for some time and this continues. Post the wash-up of the reporting season this time around though, we now conclude it has been the worst in many years. This presents as an insidious dichotomy…on the one hand prices continue to rally but earnings have been downgraded the most in a long time. We wonder what will give first…do prices fall away or do earnings somehow miraculously recover? We take the former view exiting the month of August 2018 with 9% net market exposure i.e. effectively fully hedged. The Australian market was clearly lifted in certain sectors due to the read through from US sector performance with the tech-heavy NASDAQ rising over 5%. This translated to the Australian Information Technology sector rising almost 13% as well as the pseudo-Technology sector which we will name as Australian Healthcare sector rising 10%. The Materials sector fell by nearly 5%, partly explained by its correlation with the copper price (among other base metal prices) which fell 5% as well. The Energy sector fell 1.3% against a backdrop of a rallying oil price where Brent Oil rose near on 5%. The main culprit leading to underperformance in the energy sector was Origin Energy (ORG) which fell 19% due to disappointing guidance in their electricity business. Please note ORG benefitted, as did AGL Energy (AGL), from rising electricity prices over the past couple of years and they are now both seeing the other side of the commodity cycle. In Europe, markets were generally sold off across the board of a magnitude close to 3%.

APSEC FUNDS MANAGEMENT

Looking at the reporting season in more detail, we present the following chart from the HALO Investment Research Platform. The chart below highlights the extent to which earnings have been positively revised in the market. The green area chart highlights the share of positive revisions. We have highlighted two instances over time. The most recent red circle corresponds to the current reporting season. Overall through this period, around 33% of companies (by market weight) had positive revisions. This is not the hallmark of a strongly rallying market. The prior instance relates to the August 2015 reporting which was mired by significant downgrades to Resource companies. In contrast, the recent earnings downgrades have been much broader affecting more and more sectors. To reiterate, this does not generally present as a supportive environment for rising share prices despite the recent lift from the US market. As is always the case during reporting season, there were a few companies that appeared to defy gravity i.e. a number of "beloved" companies continued to rally despite sizeable downgrades to earnings. Domino's Pizza (DMP) provided a ludicrous update in our view suggesting they would significantly improve earnings despite not meeting their same store sales targets (very material downgrade for the first time in a long time) with the expectation that EBITDA margins would bounce back. For a scale business, one would expect margins to remain in uptrend but following this latest report they have been materially decimated. Despite this downgrade to operating margins, the stock has continued to rally against a backdrop of sticky analyst forecast earnings growth and roll forward target price upgrades, rising bond yields (which tend to be a dampener on companies with high valuations) and a deteriorating Australian consumer under the hammer from rising mortgages & utility prices. We will await further strength to sell into as we don't believe next year's report will end well. Similarly, Cochlear (COH) downgraded earnings quite materially, circa 5%. COH is a relatively mature company which has earnings growth forecasted around 11%+ in perpetuity despite achieving less than 10%. But what is more remarkable is the company's valuation trading on 26x EV/EBITDA. This is extraordinary, and it doesn't abate for many years into the future. Post their report, the company's shares fell initially but then continued in a very strong upward trajectory, moving into an extreme overbought state by months' end. It remains inexplicable to us as to why an institutional investor bought at these prices.



Fund Activity

Given it was reporting season, we usually enjoy this time of year as it provides updates on companies that we have been following closely as well as providing new information for new opportunities. However, we were more cautious this time around due to valuation concerns and the way in which company prices moved into reporting events. But before we attend to some discussion on the companies we found compelling, we will discuss a position that could have been ended significantly in the red for the Fund. Prior to the start of the August 2018, we had started to accumulate a position in Eclipse (ECX). The company was relatively cheap, appeared to be able to meet guidance in most of the businesses we were able to channel-check against with growth expectations by market analysts appearing below company guidance as well as not reporting until November 2018. However, several days into the month of August 2018, the company downgraded their growth expectations from ~27%, down 13%. Ordinarily, one would have thought an adverse price outcome of around 15-20%. But instead the company's shares were sold down 40%. Given valuations on the lower earnings growth were now close to 7-8x, we chose not to sell the shares but instead bought more knowing the company was too cheap not to

Source: HALO

be taken over if it remained at these prices. We extended our position up to 1.5% buying the tail of the candle (as show in the graphic to the above: Blue=Buys, Red=Sells) and in just over a week later a takeover offer was forthcoming. Often there is irrational behaviour in equities markets and clear thought in what appears highly stressful situations brings out the best in us. We have since sold the position around the recent highs, the net result being a small loss.

Otherwise, there were a few standouts over the month which contributed to returns. On the long side, Altium (ALU) provided supercharged returns relative to where we bought and sold the position. While we knew that technology stocks were very much in vogue, we saw very little to be excited by given prices had traversed so strongly. We were looking for a strong signal to enter names which consisted of the potential for an earnings upgrade but where prices had materially pulled back prior to their reporting. In the case of ALU, the classic setup as provided by the Fakey-Shakey Long signal from HALO enabled us to enter at ideal levels. This signal highlights our underlying philosophy to always be on the backfoot when buying companies rather than rushing into a position. Anyone can buy a stock but in our view it always about timing. We highlight in the chart to the left where we bought our position (Blue box), the day of the event as well as when we sold. The selling decision is also driven by a HALO signal, in this case a signal that highlights an extreme overbought state. This again is congruous to our underlying philosophy of always being on the backfoot, only we flip this mentality to when we sell. In other words, while the rest of the market is exuberant in buying stock we now sell into this strength. There are countless examples over time and across different markets where the first couple of days post a report the price action is essentially represented after which there is natural decay. We always respect this in price behaviour and as it turns out we optimised the buy and almost the sell by merely being patient. On the short side, we again were patient in entering a short position in Challenger Financial (CGF) as per the chart to the left. (We have shown the recent historical buys and sells as well). In years gone by, we have been positively disposed to the company having identified the opportunity in 2013. However, every company has their day. In the case of CGF, we have taken the view that dilution from their recent capital raising with their Japanese partner, together with slowing growth in annuity sales and their life book would lead to a high probability of an earnings downgrade. Once again, the Fakey Shakey signal prepared us in timing the short entry into this name. As it turns out the downgrade was quite sizeable with expected ROE targets, which they have been consistently met over time, had to be downgraded.

Source: HALO

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Outside of a generally successful reporting season campaign (although we did miss Costa Group (CGC) which would have been a great contrarian trade having rallied into their result!), a few stocks dampened returns sufficiently for us to print a negative. Of note was Mesoblast (MSB) which fell ~25%. We have diligently held MSB for over a year now through the very volatile ups and downs. During August 2018, the share price retraced for no apparent reason albeit the share price was up 40% in July 2018 post the announcement of their strategic alliance with Tasly Pharmaceutical Group. This provides an entrée into the Chinese cardiovascular treatment market. Generally, Mesoblast has been a "whipping boy" of many hedge funds with short interest rising 2% to 6% over the past year. In many respects this is related to their equity capital requirements but in our view, this is now a very dangerous short-sell investment. The reason we say this is that there are numerous significant events looming over the rest of 2018 which makes this one of the most exciting bio-tech companies in the world. In the first instance, we expect 180-day efficacy data (read: survival outcomes) to be released on their acute Graft versus Host Disease (aGvHD) Phase 3 trial which relates to a specific life-threatening disease post bone marrow transplants. In their case, they have focussed on a paediatric cohort. We expect the results to remain consistent with earlier readings and expect them to release their findings over the first half of September 2018. If they can show consistency, then a fast track through the US Food & Drug Administration may be allowed. Once through the USFDA, the company would be the first company in the world to commercially manufacture a allogenic cellular medicine (read: stem cell) into the US – an amazing achievement. The company also has many other trial data to be released over the rest of the year related to enormous markets including heart failure (Phase 2/3), chronic back pain (Phase 3)(potentially replacing drugs associated with the opioid endemic) and rheumatoid arthritis (Phase 2 – early days!). We will keep investors posted on these developments but suffice to say if they are successful in any one of these additional markets it will most likely lead to strong share price performance.

Risk Statistics

	Fund		Index	
	3 Year	Inception	3 Year	Inception
Alpha (%pa)	-8.5%	-0.8%		
Downside Capture	58%	56%		
Standard Deviation	6.0%	8.1%	10.5%	10.8%
Sharp ratio	0.2	0.9	1.1	0.7
Sortino		1.3		1.3
Largest Drawdown	-7.1%	-7.1%	-13.7%	-13.7%

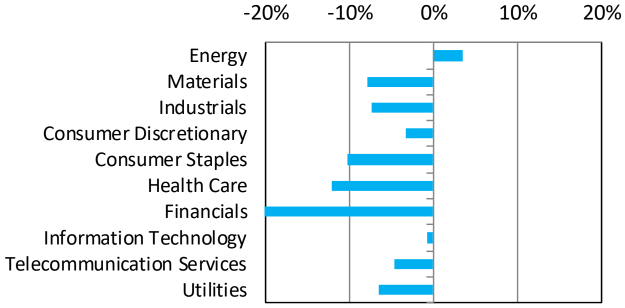
Exposure

	Long	Short	Net	Gross
Equity	50%	-9%	41%	59%
Index Futures	0%	-32%	-32%	32%
Net	50%	-41%	9%	91%
Cash			91%	

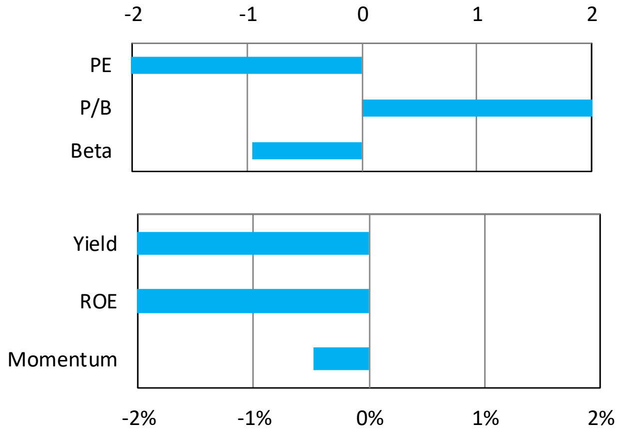
Contribution

Positive	Negative
Altium (Long)	Bellamy's Australia (Long)
BHP Billiton (Short)	MesoBlast (Long)
Challenger Financial (Short)	Norwood Systems (Long)
Service Stream (Long)	Universal Coal (Long)

Sector Exposure



Factor Exposure



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 (ex Dist)	1.2150	Application Price (ex Dist)	1.2162
		Redemption Price (ex Dist)	1.2138

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Important information