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Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

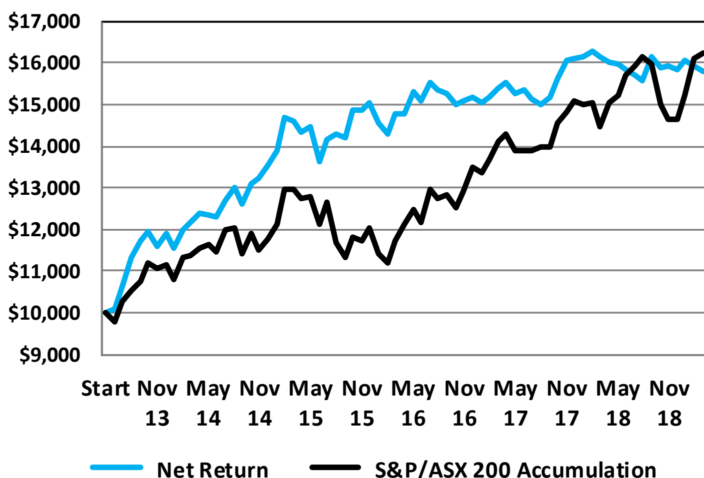
Fund Quarterly March 2019

Return Summary (To March 2019)

Period	1 mth	3 mth	6 mth	1 yr	3 yr (pa)	5 yr (pa)	Cumulative	Per Annum
Fund Return	-1.01%	-0.4%	-2.1%	-2.3%	2.3%	5.6%	57.9%	8.0%
S&P/ASX200 Acc.	0.73%	10.9%	1.8%	12.1%	11.5%	7.0%	62.4%	8.5%
Excess return	-1.75%	-11.3%	-3.9%	-14.4%	-9.2%	-1.4%	-4.5%	-0.5%

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 first quarter of 2019 saw a complete reversal of the last quarter of 2018 taking us much by surprise, rising almost 11%. These are turbo-charged returns at a market level requiring some analytical explanation. Was it that earnings expectations had changed materially during the quarter? The February to April period (relative to August to October) is typically the reporting period that tends to turbo charge returns the most, either in anticipation of good earnings or alternatively due to an "after-the-fact" rally. Historically the average over the past 25 years for February to April has outperformed the August to October period by a factor of over 3x! As to the actual earnings revisions, they were revised aggressively downwards marking one of the worst reporting seasons in over 10 years at an aggregate level. We had anticipated this and had accordingly reset our own expectations in terms of overall market exposure. But to our dismay, the market rallied.

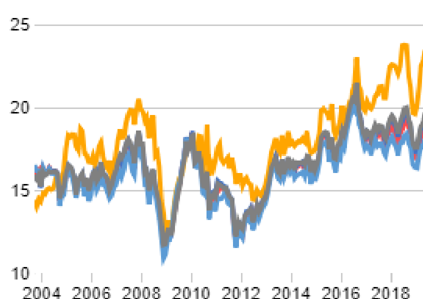
Given that short term economic activity indicators remain sluggish, we wonder why investors remain so bullish. Of course, there are sector specific themes that have played out over the quarter. The Australian 'Tech' sector remains hot with "lay-by" companies now fetching ever increasing valuations which we have never touched as essentially, they are short capital albeit they are ameliorating this via syndicated debt. This differs to other tech companies we have been exposed to as they have represented new concepts, rather than simply a bet on an old market (i.e. financial

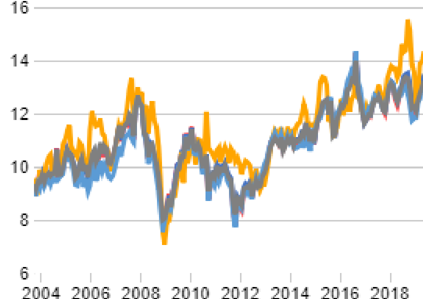
disintermediation) which when the cycle turns, which is undoubtedly obvious, you will not want to be exposed to these companies as they are a proxy for the credit cycle i.e. they either get hit by credit losses or they dial back risk. Other tech companies that have done astoundingly well include Appen (APX:ASX – Language Technology), Bravura Systems (BVS:ASX – Wealth Management and Fund Administration Back-office Technology) and Nanosonics (NAN:ASX – Medical Device Technology) all of which we have held at various points in time but given lofty valuations have appeared "too-hot-to-handle". In many cases, tech companies were de-rated 20% over the 2018Q4 only to find them bounce at least 50% with no discernible upsize in earnings revisions. Admittedly growth expectations have remained strong but for each of the tech companies noted above, not one has been revised dramatically up and in most cases a continuation of out-year downgrades has ensued. We don't really understand this dynamic and so we don't understand how these prices have been achieved. The other sector of note was the resources sector, and in particular the names associated with Iron Ore. Severe supply issues impacted the commodity with dam-related supply cessation occurring in Brazil, new legislation in Brazil to prevent further disasters and severe weather events affecting supply in the Pilbara. In all, this led to super charged returns to many of the Iron Ore players, with Fortescue Metals (FMG:ASX) benefitting the most. This was further amplified for FMG by earnings revisions of over 100%...how could market analysts have been so wrong? This is probably one of the most amazing revision cycles we have seen in our life as analysts.

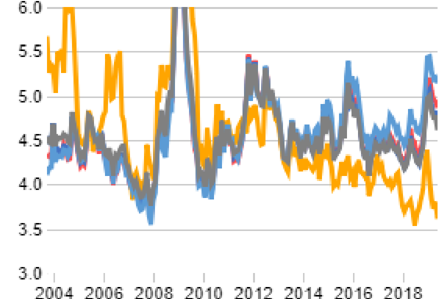
So what else could it have been that made market participants so bullish or at least bid markets back up to the top of the range? Bonds rates often portend what economic conditions are likely to be in the future. As activity indicators and company earnings started to come off globally during October 2018, so did bond rates (see graphic on right). This has been a continuous feature (bond prices have rallied) since then subject to the normal on-trend rallies from time to time. So, it is unlikely that the direction of bonds is an explanation as they have been one-directional while equity markets have fallen ~10% and then rebounded ~10%. Hidden underneath though lies an explanation and the market expectation that we missed over the past 3 months. Essentially, it was not so much about the direction of bonds as it is clear the peak in this economic cycle is behind us, fuelled by ever increasing debt much larger than what precipitated the onset of the GFC. It has been all about the relative price of current money vs long duration money i.e. the yield inverted leading to some disastrous expectational outcomes. But once expectations of "it isn't as bad as we thought it was going to be" had started to filter through coupled with a less aggressive US Federal Reserve Board (in some market participant eyes this was the Fed Switch, we liken it to the Fed Twitch), this certainly unleashed liquidity back into risk assets. So, on the one hand, we had done well in the prior part of the bond traversal, we have underperformed on the bounce. To our way of thinking, this is not ideal but is within the parameters of managing the Fund as we have set out.

Source: IRESS

A few charts to explain what you are actually buying in this current debt-fuelled asset price environment.

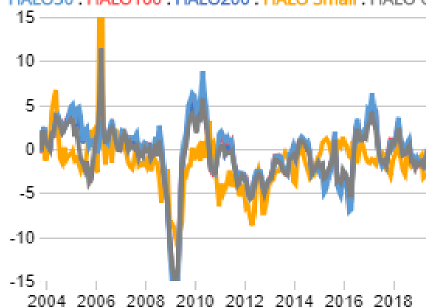


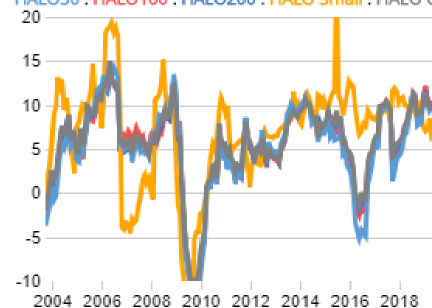




The extent of valuation expansion remains worrisome particularly against the backdrop of weakening domestic earnings,

the domestic housing wealth affect and general global cyclical issues. The levered adjusted valuations (EVEBITDAs, despite generally lower debt ratios compared to say 3 years ago) remain too high in aggregate. For Small Caps, you are paying over 14x on average. This is at least 15% too high relative to this part of the cycle in our view. Offsetting this to some extent are higher than usual dividend payout ratios as we race into the Australian general election with companies looking to maximise the window of opportunity to release franking credits. But this opportunity has now passed (for the most part, banks excluded with their awkward reporting cycle) with current 1 year forward yields exaggerating future aggregate yield as the current fiscal year dividends have now been paid. Overall, valuations are not compelling up here even with the help of lower bond yields. For the "half glass full" types who see lower rates as making assets cheaper, be careful. Eventually economic activity cracks and there is a reason bond yields are so low!





On the earnings side, they have come under pressure over the past two reporting periods with aggregate earnings remaining weak with around 40% of companies not having negative revisions i.e. 60% of companies for which there are estimates have been revised down. Forecast earnings growth has now slowed to single digit for the very large and the very small. Mid-caps appear to be holding ground. Meanwhile Dividend per Share growth remains elevated. In this environment, where the economic cycle is clearly impacting earnings, would you be comfortable holding a market portfolio at what appear excessive valuations? This is certainly not the case in our view and we remain vigilant, choosing instead to focus upon specific opportunities.

Fund Activity

Overall, Fund activity has been much lower over the past quarter simply because we have come out of a falling market and didn’t think equities would be re-priced as aggressively as they had. Notwithstanding, we have had some good performers and some not so good ones. Our general construct is that we are looking for divergence where we believe assets are under-priced i.e. the classic asymmetric investment relative to the market environment one is in. We are also generally on the lookout in the first quarter as the returns from the Reporting Season tend to be outsized so statistically there is a bias. But having anticipated a weaker environment for earnings we dialled back risk in general. This will always be a feature of our process for the Fund as the focus on capital preservation is paramount. Notwithstanding, there are a number of note-able mentions.

For quite some time, we have been researching Cleanaway Waste (CWY: ASX) and generally have a positive bias. Importantly, we have been looking for an asymmetric setup. You can see the trade points highlighted by the purple arrows below, generally sparse over time. We had previously traded the company on the short side in early 2018 where the company showed elements of buying exhaustion. A year had passed with the company’s share price retracing to where they had been where we had covered the short position. Due to a number of days of institutional dumping (just prior to Christmas and post new year) we elected to accumulate a position on each of those days. This was against a general backdrop of plummeting equities into Christmas and we had been looking for long positions to offset our overall low market exposure. The thesis is generally simple. They are long markets which are consolidating (Waste collections across Solid, Industrial and Liquids), they are a consolidator through acquisition (eg ToxFree) but more importantly they have had very strong organic revenue growth which is expanding margins. Industry conditions remain supportive with waste, in aggregate, a GDP+ sector growing at multiples of population and underlying GDP growth. Post providing a positive update in February 2019 (i.e. the company remains in an earnings revision uptrend) we remain invested. We remain watchful on industry developments which may impact the overall improvement in margins. A case in point is the impact our other position in the sector, Bingo Industries (BIN:ASX), had on Fund returns. Essentially, because of the downgrade in their earnings much to our dismay, our profits in CWY were neutralised. BIN cost the Fund 90bps in performance. There have been a number of corporate events where it appears that investors have been hoodwinked and where we have been impacted over the last 6 months. For example, Lend Lease (LLC:ASX) is an example of where there is an active class action. While we quite rightly are happy to wait for legal proceedings to play out, the circumstances surrounding the BIN downgrade should also be investigated with business indications by the executive group being quite the opposite only 3 months earlier. All investors are helpless in these situations where management appear not to be providing a timely picture of their underlying business and it certainly goes to show that one has to be careful in getting involved in “dirty” business particularly in light of the drivers of the downgrade for BIN i.e. softening construction activity and no price rises which in and of itself was a major surprise.

Another core holding the fund has maintained for quite some time is Macquarie Group (MQG:ASX). The trajectory of earnings has generally been attractive for many years now as they increased their exposure to Asset Management Fees. Gone are the days of huge cyclicality in their earnings profile and thus they remain the “staple” large capitalisation financial institution that we invest in. In comparison, we have been bearish (relative since inception and absolute for the past 4 years) on Australian Banks since inception and remain so as the leverage to the Australian Housing sector we believe is under-appreciated which is now only starting to show up in credit delinquencies. As represented in the chart to the right, MQG fared poorly during 2018Q4 falling 20%. This was an outsized downdraft but nonetheless we accumulated further with the last transaction occurring on the day before Christmas. Probably of more interest to us, and you the reader hopefully, is that the signals that we use to accumulate quality companies remains as strong as it has ever been. On the basis of the clustering of blue triangles (see chart to right), which represents the double-trend, mean reversion signal called the “Fakey-Shakey” in HALO, it certainly gave us confidence in accumulating further. There are very few companies over the past couple of years that have consistently shown this signal to only bounce off these levels and deliver performance. Importantly, there have been very few tactical sells against MQG which is rare as well. But this is not some quantitative artefact. This signal simply confirms the underlying trajectory of a company’s fundamentals which should be a prerequisite for outperformance in anyone’s language i.e. if a company’s earnings are not improving then it is near impossible for a price to rise. Turning points in earnings are obviously something that the signal cannot predict but where company conditions are relatively stable we must, like the rest of the market, “believe” in persistency. Our overall view on MQG remains strong albeit that valuation is now near multi-decade highs despite low absolute levels. Of course, given their increased exposure to underlying assets, the cyclical nature of their earnings (in our view, pretty much all companies will show cyclicality at some point in time) will show up once asset prices fall enmasse which doesn’t look like happening anytime soon with significantly accommodative monetary policy. I suspect we will be telling the opposite story at some time in the medium-term future.

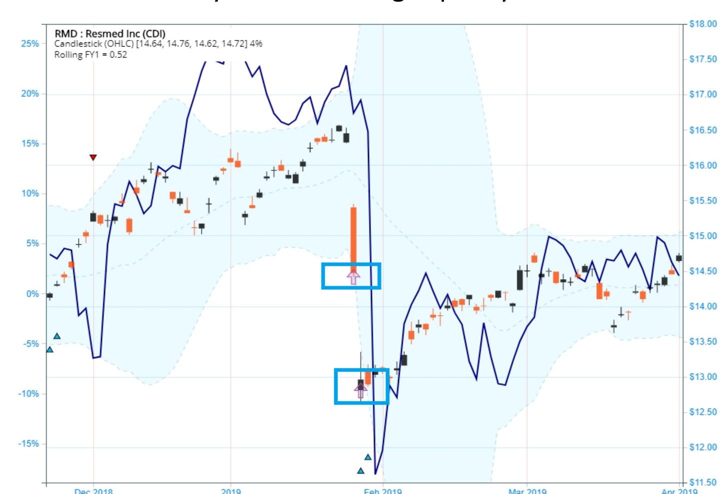
On the reporting season front, we had been quite specific about our exposure, partly because many companies had rallied in advance of results from the bounce at the start of the quarter. Webjet (WEB:ASX) was a prime example on how we attempt to optimise the entry point into a reporting season event. Essentially, we are after companies where expectations are low but where there is a high chance of upgrade. The history of the WEB price has seen huge volatility over the past year with returns of 70% up to the peak (with significant overbought signals), then for all those returns to have evaporated into the start of this year. Very peculiar price behaviour indeed and goes to show how frothy markets can be despite nothing materially changing in the outlook of the company. In any case, we took the view into the reporting season that the company would upgrade earnings at least slightly. Surprisingly, the company made no material changes to their forecasts and yet the price of the equity moved from $11.37 on the day prior to their report to a high of $16.71 two days later. This is extraordinary price behaviour and perhaps needs further explanation as at a high level this really makes no sense. The company is comprised of two main businesses and seeing how these have evolved over time is key to understanding the future dynamics of the company’s earnings. The company started life with their online interface which many of you may be familiar with. This business has undergone significant growth in revenues of around

AUD$1m 15 years ago to now revenues of approximately AUD$150m. This business alone supported the share price for a decade of more. But this wasn't the business that we were focussed on. It was the WebBeds business that the company has recently started to build and what a cracker business is has become. This business during the latest half of reporting has now exceeded the EBITDA contribution from the old business. It has grown EBITDA from almost breakeven a couple of years ago to now contributing AUD$30m. This has been driven by recent consolidation in the sector where they have leapfrogged to #2 globally with the recent purchase of "Destinations of the World". And while it is early days with the current optimisation of the acquisition, we remain favourable on the future dynamics of the company. Ordinarily we would generally liquidate after such a strong short-term run, but we have taken the view to maintain the holding and top up tactically when we can.

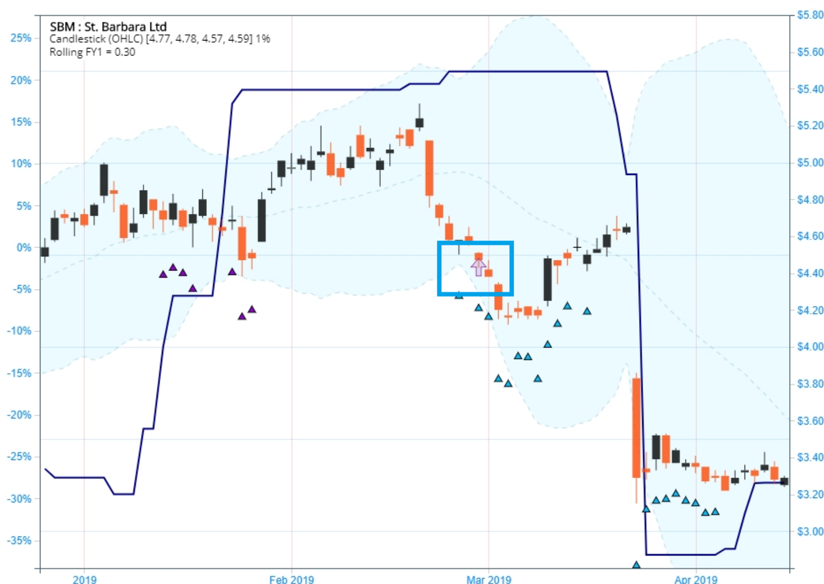
Often it is the case when considering investments from a deep value perspective, one must take the short term and look through the cycle with the foresight to understand the long-term company dynamics. This can often lead to some capital impairment in the short term if one doesn't get the timing right but overall, we have found these investments very rewarding for Fund investors. Many examples come to mind where we took a contrarian view including Challenger Financial Group and Premier Investments in 2013 and it is something we look for from time to time. One such investment the Fund made in December 2018 was in Japara Health Care (JHC:ASX). This company belongs to a cohort of companies that have been severely punished over the past three years including Regis Healthcare (REG:ASX) and Estia Health (EHE:ASX). In each case, the equities came off around 80% from their prior highs even despite the fact that they remained solvent and were likely to remain in business for the long term. A large component of the price downdraft came about due to the Royal Commission into the Aged Care Sector with lingering concerns weighing on share prices. As is quite often the case, when changes in the regulatory environment are afoot, the underlying expectations of value by existing holders become paramount to understanding future price dynamics as well as the likely short interest from hedge fund managers where a regulatory outcome is negative! The companies are in the Aged-Care housing sector, an important evolving industry in the Australian economy as the aging population moves into retirement phase. This industry had very positive regulatory headwinds until there was a sense that the operators were gouging. This remains to be confirmed and it is most likely that the companies where merely operating within the incentive structure afforded them, but nonetheless at some point the pricing of equities become so out of whack that further work is required. We took the view that after the shock value of the Royal Commission that we would wait to see where prices stabilised and accumulated accordingly. We remain invested at the time of writing but remain on alert to any major downgrade to industry forecasts.

On the negative side for the quarter, it appears we entered a few names prematurely with some material downdrafts in performance. One such name was Nufarm (NUF:ASX) which cost the Fund in February and March 2019 cumulatively 75bps. The company has been beaten up for over a year and started to present some valuation support subject to the recognition of more normal weather patterns in Australia. This unfortunately hasn't occurred and the company has undergone further significant downgrades which the Fund was exposed to. In the short term, the Fund was impacted, however we are looking through the short-term issues while at the same being cogniscent of elevated gearing levels. Longer term, there are some positives on the horizon which, if they are successful in executing will support the performance of the equity over coming years. In particular, their foray and first-to-market strategy of providing an alternative source of Omega-3 products should be an evolving thematic for the company over coming years. These products are currently supplied by aquaculture and the company is looking to replace this supply constrained market with the first land-based Canola Oil feedstock. First step will be to harvest their first crop and deliver into the fish-feed market after which we imagine there will be opportunity to expand their target markets. It appears the company is on the cusp of a significant market and time will tell whether they are successful. In and around the profit downgrade we traded the position to improve the short-term profit outcomes on the Fund. Notwithstanding, while the share price has recovered somewhat recovering some of the losses, we are tactically reducing the size of the position into June year-end tax-loss selling and will look to re-load opportunistically in the new Fiscal year.

We also took aim at Resmed (RMD:ASX) over February post their downgrade. On the basis of the chart to the left, the price performance was quite shocking. For a short-term downgrade of around 5%, to see the stock down 12% by days end was extraordinary. For such a high-quality medical device company which has continued to show continuous growth, to be moved so much made no sense to us. There have been many instances where downgrades in large capitalisation healthcare companies have led to rallies post event. Not because investors are impressed with the results but simply because the sector has been bid up for so long. This has occurred in both CSL (CSL:ASX) and Cochlear (COH:ASX) at various points in time. Curiously with COH during the last reporting season, they rallied over 10% which we were lucky enough to short! Even so, the law of averages would suggest where a price move is not warranted by the size of the downgrade, it is typical for the share price to rally. But in RMD's case it fell a further 10% the next day of available trading. Now this in itself seems strange enough but the reason for this dynamic is that the are at times very unorthodox price dynamics in RMD due to its dual-listed structure. As it turns out, the Australian market in RMD was closed for a day (due to the Australia Day weekend) while the US market in RMD traded post the 10% down day in Australia down 20% into the weekend. When the company's shares re-traded, they had to fill the gap between the fungible US stock! What turned out to be what we had thought to be a good trade turned into a very unwelcome outcome for the month of January 2019, costing the Fund 50bps. Since the initial plunge in the price the company's shares have contributed positively and we remain invested.



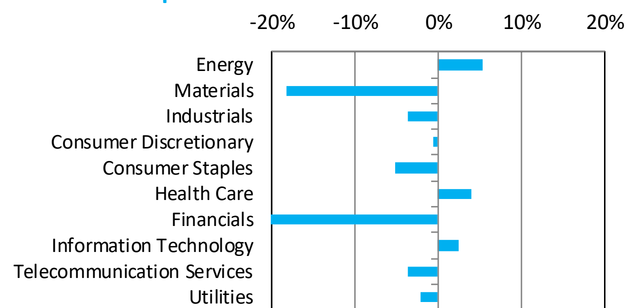
Finally, the Fund's position in St Barbara (SBM:ASX) was not an outcome we were expecting. It is fair to say this came out of the blue and accordingly the share price was dealt with. The position cost the Fund around 40bps and is unlikely to be recovered anytime soon. The reason for the re-pricing relates to a development study they released to the market. The company's main mine, Gwalia, has been operating for over 100 years. Every now and then, the mine is assessed for development potential. Over the last decade, the optionality in the mine is generally related to going deeper underground. Typically, this will also involve higher costs so in order for these deeper projects to make a meaningful contribution, the projects generally require a larger scale. Throw in geological issues (grade, ore body shape, etc) and other geophysical properties, and one can understand how uncertain many mining projects become. As it turns out, pretty much every single operating parameter was adversely affected (ore body shape, method of extraction) leading to a material downgrade to expectations. These things happen from time to time particularly in relation to mining entities, but we admit it was certainly unwelcome.



Risk Statistics (As at March 2019)

	Fund		Index	
	5 Year	Inception	5 Year	Inception
Alpha (%pa)	-1.4%	-0.5%		
Downside Capture	43%	47%		
Standard Deviation	5.5%	7.9%	9.5%	11.0%
Sharpe ratio	0.5	0.8	0.5	0.6
Sortino		1.4		1.5
Largest Drawdown	-7.1%	-7.1%	-13.7%	-13.7%

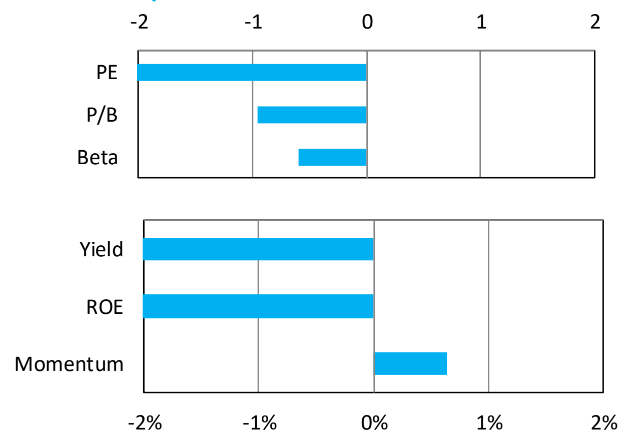
Sector Exposure



Exposure

	Long	Short	Net	Gross
Equity	54%	-3%	51%	57%
Index Futures	0%	0%	0%	0%
Net	54%	-3%	51%	57%
Cash			49%	

Factor Exposure

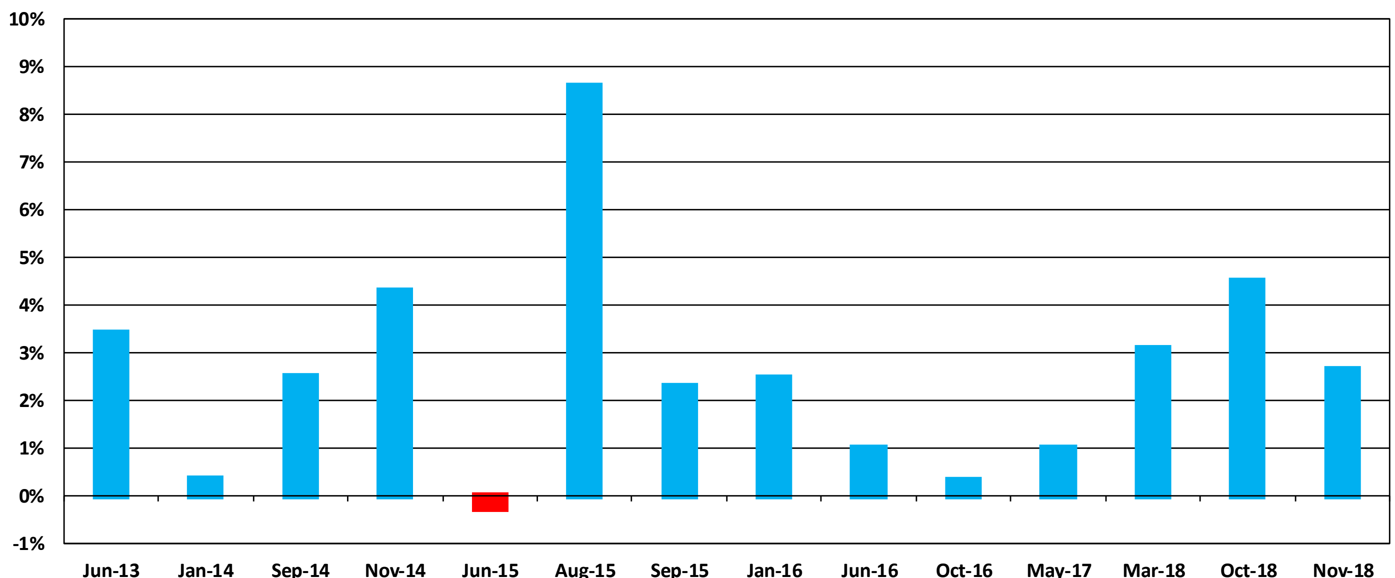


Source: APSEC Funds Management

Contribution

Positive	Negative
Adelaide Brighton (Short)	Nufarm (Long)
Cleanaway Waste (Long)	Paladin Energy (Long)
Mesoblast (Long)	St Barbara (Long)
Wesfarmers (Long)	Universal Coal (Long)

APAEF Relative Returns (From Inception)
When the market is down more than -2%



Source: APSEC Funds Management

Fund Information (As at March 2019)

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)	1.2313	Application Price (ex Dist)	1.2325
		Redemption Price (ex Dist)	1.2301

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Important information

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