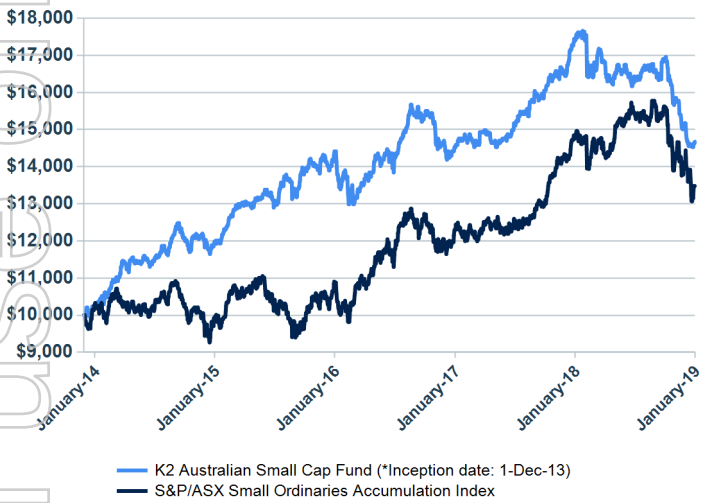
K2 Australian Small Cap Fund (Hedge Fund)
31 December 2018

	1 Month	3 Months	1 Year	3 Years (%pa)	5 Years (%pa)	Inception (%pa)	Inception Date
Performance (Net of Fees)	-3.3%	-13.2%	-15.9%	0.6%	7.4%	7.8%	1-Dec-2013
Average Net Exposure	32.5%	52.0%	73.7%	79.5%	77.7%	77.3%	

Growth of $10,000



Commentary

The K2 Australian Small Cap Fund returned -3.3% for the month of December while the ASX Small Ordinaries Accumulation Index returned -4.2%.

Despite a near 3% rally from the lows in late December, the Small Ords delivered its worst quarterly performance in over 5 years (-13.7%) with the Small Cap Industrials sector (-13.7%) having their worst quarter since the GFC (December 2008). Volatility was a key feature over the month with almost 60% of the daily small cap index moves being ±1% and the A-VIX averaging 17.6 during December which is 25% higher than the post QE2 seasonal trend. While higher growth companies have derated in line with the market, it is those lower PE, "value" companies which have dramatically underperformed. Rather than providing valuation support during this sell-off, the market has further discounted these companies due to the perceived earnings risk.

The Consumer and Financial sectors were the largest detractors for the month while the Fund's short positions contributed positive performance. Specifically, Althea (AGH AU) suffered on the back of a short sellers report targeting its major strategic investor, whereas Cedar Woods (CWP) and Elanor Investors (ENN) experienced a derate on the back weaker housing data.

We are concerned that the Australian economy will contract meaningfully in 2019. The weakness in equity and property markets for the December quarter will most likely lead to a $300 billion decline in Australian household net-worth. This "wealth effect" is already impacting consumer activity; national passenger car sales for the December quarter were 23.7% lower than last year. Housing activity was also subdued; national auction clearance rates for the December quarter averaged just 47% and national property prices fell 6.2%

(commentary continued next page)

Top 5 Stock Holdings	Current	Monthly Move
Elanor Investor Group	4.0%	-0.2%
Cedar Woods Properties Ltd	3.2%	0.0%
Healthia Ltd	3.1%	-0.4%
Metlifecare Ltd	2.7%	+0.0%
Axsesstoday Ltd	2.6%	-0.5%

Month End Exposures	Current	Monthly Move
Consumer	5.6%	-2.3%
Financials	13.3%	-2.1%
Health Care	7.0%	-3.5%
Industrials	4.1%	-1.0%
Information Technology	1.2%	-0.3%
Materials	2.1%	+0.1%
Real Estate	3.2%	-0.7%
Utilities	0.7%	-0.6%
SHORTS	-6.4%	-0.1%
Number of Positions	**29**	**-9**
Gross Equity Exposure	**43.3%**	**-10.2%**
Cash Weighting	**69.4%**	**+10.4%**
Net Equity Exposure	**30.6%**	**-10.4%**

Fund Characteristics	
FUM	AUD $24m
Portfolio Managers	Campbell Neal, David Poppenbeek, Josh Kitchen and Nicholas Leitl
Strategy	Australian and New Zealand Small Cap Equities
Objectives	To deliver consistent absolute returns over the investment cycle with a focus on capital protection during periods of market declines.
Return Target	+10% pa over the long term
Number of Stocks	Up to 100 stocks
Cash	Up to 100% of portfolio
Distributions	Annually
Management Fee	1.31%
Buy/Sell	Bought and Sold on the ASX market (ASX: KSM)
Performance Fee	15.38% p.a. of the amount by which the NAV exceeds the High Water Mark once the fund achieves its hurdle.

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for the year. We feel that the first half of 2019 will see a continuation of restricted consumer activity particularly given the near term policy uncertainty associated with the forthcoming Federal election and the release of the Royal Commission's final report into the Misconduct in the Banking, Superannuation and Financial Services Industry. As a result we would expect business confidence to move lower over the coming months and subsequently we consider it probable that Australia's unemployment rate will rise in 2019. Ultimately we believe that a contracting domestic economy will lead to lower earnings projections with dividends at risk.

Given the liquidity risk and earnings volatility inherent within small companies, a weak economic backdrop is not a conducive environment for small cap investing. As evidenced over the past three months, volatility is magnified in the small cap space as liquidity takes priority over value. We are also wary of the impact that passive investing has had in the small cap index which further exacerbates the volatility, especially in a deteriorating earnings environment. Accordingly the Fund has been raising significant levels of cash over the past three months, with net equity exposure ending the year at 31%. While the process has been difficult and resulted in some negative short term performance, we feel this is the most prudent approach and the Fund is now in a far better position to withstand a difficult investment environment. Also, with significant levels of cash, the Fund can take advantage of opportunities which may present themselves over the coming year.

In the short term, we anticipate the upcoming reporting season in February will be a catalyst for further earnings downgrades across the small cap universe. Expectations of 13% earnings growth over the coming year seem far too optimistic given the economic backdrop, and despite valuation support in some sectors, the Index weighted PE of 17x leaves little room for disappointment.