

Optimal Australia Absolute Trust

Optimal
FUND MANAGEMENT
AUSTRALIA

Monthly Report | July 2016

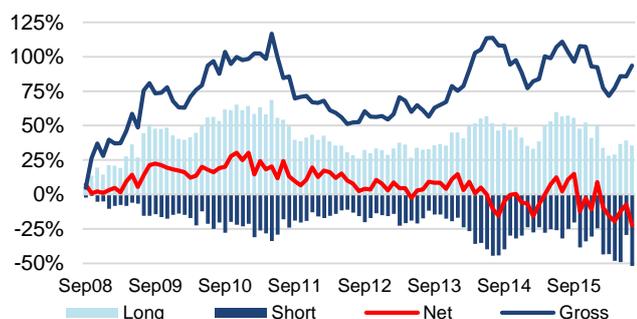
	Month	Qtr	Year	Life (p.a.)
Fund returns	-2.3%	0.1%	8.4%	8.8%
Series 1 NAV				\$10.625
Positive months			75%	86%
Worst month			(2.3%)	(2.3%)
Volatility				3.8%
Sharpe ratio				1.2

Monthly key contributors - by sector	
Longs	
Positive	Insurance, media, banks, builders
Negative	Staples, resources
Shorts	
Positive	-
Negative	Healthcare, media, index futures

Cumulative performance



Fund investment profile (% NAV)



Risk settings

% of NAV	Long	Short
Equities	35.6%	(57.9%)
Debt / Hybrids	0%	0%
Derivatives		0%
Gross exposure		94%
Net exposure		(22%)

Concentration by position	Long	Short
Top 5	19.2%	-25.8%
Top 10	28.7%	-44.6%
Top 15	34.5%	-55.5%

Performance Review

Trust units are now priced ex-distribution (\$0.265 for Series 1), and recorded a -2.3% net return in July.

After posting a solid +11.2% return in a flat and volatile market in FY2016, we found July to be a tough month. We did not expect markets to forgive Brexit with quite such rapidity. While we expected Brexit to be a trigger for more central bank liquidity creation, we've still been taken aback by the size of fresh "bond refugee" and risk-parity money flows into higher carry markets. The panic for yield has driven USD 17bn into emerging market debt funds in the last 5 weeks (annualising at 13% of AUM), and a huge rally in AUD long bonds, to an all-time low on the CGS 10-year during July, at 1.82%.

We're convinced that such unnatural crowding in equities will end very badly, but timing remains key. The Fund's net short exposure during July was a big drag on returns as our equity market featured outsized gains. With a rising AUD, the 200 index gained 8.5% in USD terms, hugely stronger than international peers – e.g. US' S&P 500 +3.7% and the more directly Brexit-and banking sector-impacted Euro Stoxx 50 +5.2%.

Our bias against interest-rate sensitive stocks proved expensive as a means of hedging portfolio risk. While paying careful attention to risk controls, we will persist in using stocks in this category as shorts, as yield-seeking investors have taken many such stocks to valuations that are indefensible on any non-yield metric, while ignoring some of the cyclical and financial leverage issues that represent real sources of capital risk.

A number of our long investments also disappointed. Our small investment in lithium producer Orocobre has been a big winner for us this year, but the stock price was pressured with the usual set of communication issues around the company's 2Q production report. We have been patient in building a small investment in Incitec, fully aware that spot pricing of key inputs were much less favourable than consensus estimates, but further earnings downgrades during the month proved not to be discounted to the extent we expected.

Optimal Australia Absolute Trust

Fund Strategy

We maintain a defensive focus. Equity markets, especially Australia's, recorded superb returns in July, but there was no supporting upwards revision in earnings, and it's unlikely that August's reporting season will drive upgrades. Markets carried by multiple expansion are generally higher-risk, especially when key drivers in the great bond rally and experimental monetary stimulus are showing clear signs of fatigue. Even the redoubtable Bank of Japan seems to be running afoul of the law of large numbers and market expectations. Crowding is getting worse, with a disturbing proliferation in structured yield products (which use equities to generate coupon, and which appear to have an asymmetric risk profile) now evident.

For the time being, these factors remain the dominant influence on equity market performance. The ASX200 REIT index, for example, returned 5.4% in accumulation terms in July, continuing a sequence of accelerating monthly compound returns, now +12% for the last quarter and +23% YTD. These growth stock-like returns have resulted in an average sector price to NTA of 148%: better hope that cap. rates continue to compress.

The Federal election did not quite play out to the Liberal/National Coalition's script. That Government was returned, but with increased reliance on minor party support in the Senate, with an immediate drift leftwards towards populist policies. Hence PM Turnbull's demand that banks explain why the Reserve Bank's 0.25% reduction in the cash rate on August 2nd was not passed on in full, apparently ignoring the offsetting impact of deposit rate increases on net interest margins.

In downgrading Australia's sovereign credit outlook to "negative" from "stable", S&P recognised the fleeting likelihood of arresting a deteriorating fiscal position. This neatly coincided with an all-time low for the Australian Govt ten-year yield. Bonds, as well as equities, seem captured by the same "bad news is good" dilemma, so neatly summarised by DoubleLine Capital's Jeffrey Gundlach:

"The yield on the 10-year yield may reverse and go lower again but I am not interested. The risk-reward is horrific. Nothing here looks good. The stock markets should be down massively but investors seem to have been hypnotised that nothing can go wrong."

Optimal Australia Absolute Trust – monthly returns

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FY
FY17	(2.28%)												(2.28%)
FY16	0.31%	1.52%	1.79%	1.42%	1.01%	(0.11%)	0.02%	0.77%	2.34%	(0.69%)	2.29%	0.11%	11.2%
FY15	1.03%	0.06%	0.64%	(0.71%)	(0.53%)	(1.53%)	(1.88%)	(0.08%)	0.98%	1.96%	2.04%	(1.09%)	0.80%
FY14	0.36%	0.14%	0.43%	0.32%	(0.52%)	0.54%	0.57%	1.06%	0.04%	0.57%	1.38%	0.63%	5.64%
FY13	(0.54%)	0.26%	0.29%	0.37%	0.57%	0.66%	0.46%	(0.50%)	(0.06%)	(0.70%)	1.22%	(0.18%)	1.86%
FY12	1.69%	0.29%	0.29%	0.97%	1.63%	(0.09%)	1.51%	1.03%	0.46%	0.46%	0.00%	(0.60%)	7.88%
FY11	2.34%	0.36%	1.45%	2.23%	1.66%	0.86%	1.36%	1.26%	0.50%	0.74%	0.57%	(1.38%)	12.57%
FY10	4.00%	3.88%	2.00%	2.68%	0.78%	0.09%	0.17%	0.52%	0.68%	1.45%	0.59%	0.57%	18.75%
FY09			0.67%	0.59%	2.19%	1.47%	1.81%	(0.56%)	3.10%	1.37%	2.43%	0.09%	13.90%

Note: returns are net of all fees and assume reinvestment of distributions. Fund inception date 15/9/08

Optimal Australia Absolute Trust – distribution history

Y/e June	2009	2010	2011	2012	2013	2014	2015	2016
Series 1 units	\$1.23	\$1.31	\$2.03	\$0.41	\$0.12	\$0.34	\$0.46	\$0.71

Fund facts

Initial series NAV	\$10.625 (ex Jul-16 distribution)	Distribution frequency	Yearly or bi-yearly (FY 2016)
Strategy	Long-short Australian equities	Minimum investment	Wholesale investors only, \$100k
Objective	Positive returns in all market conditions. Overarching focus on capital protection	APIR Code	OPT0001AU
		ISIN	AU60OPT0014
Firm AUM	\$100m	Bloomberg	OPAU SAB AU Equity
Last distribution	\$0.265 per unit (Jul 2016)	Fund inception	15/9/08 at \$10.000 per unit

This report is prepared for investors in the Optimal Australia Absolute Trust. Returns and prices are quoted net of all expenses, management fees, and accrued performance fees. This is neither an offer to sell nor a solicitation of any offer to buy Units in the Trust. Any such offering can only be made to qualifying 'wholesale investors' pursuant to the Fund's Information Memorandum, and the relevant Subscription Application.