YEARLY FUND REPORT

May 2014

Atlantic Pacific Australian Equity Fund

ARSN 158 861 155

	1 mth	3 mth	6 mth	1 yr	Inception
Fund Return[1]	-0.42%	2.88%	6.65%	23.69%	23.69%
Index	0.68%	2.76%	5.43%	16.45%	16.45%
Relative	-1.10%	0.12%	1.22%	7.24%	7.24%

Unit Price (Mid)	1.2369	$10,000	Min. Investment
MER	2.2%	$5,000	Add. Investment
Performance Fee[2]	15%	1 Jun 13	Fund Commenced
Buy/Sell Spread	0.20%	30 Jun	Income Distribution

Fund Return by Month after All Fees before Tax

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Ytd
2013	n/a	n/a	n/a	n/a	n/a	1.09%	5.08%	6.72%	3.51%	1.92%	-3.03%	2.58%	18.97%
2014	-2.67%	3.83%	1.25%	2.04%	-0.42%								3.97%

1. Fund Returns are prepared on a mid 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 ("APAEF") asset values have been calculated using unaudited price and income estimates for the month being reported.
2. Performance Fees are charged where the Fund's gross performance (before fees and expenses) exceeds the performance of the S&P/ASX 200 Accumulation Index by 3%pa and the Fund's High water mark.

Overview

A year has now passed and we present the Yearly Fund Report for the Atlantic Pacific Australian Equity Fund (Fund). There have been many opportunities over the past year, not unlike every year in equities markets. Over the year, markets were generally bullish despite entering post the announcement of tapering by the US Federal Reserve. The Fund's returns can be characterised by two halves with the first half achieving most of the gains or approximately 16%. From an alpha perspective (relative returns of the Fund to the S&P/ASX200 Accumulation (Benchmark)), the Fund achieved most of its alpha in the first six months achieving 5.5%. In the second half, the market environment had heightened macroeconomic and geopolitical risk as well as valuations reaching mid-range on average with a number of sectors trading at significant premiums relative to the market and/or to their historical valuation ranges. This led to lower overall equity exposure during the last 6 months for the Fund. The second half was tough to invest in with sectors seemingly moving in the wrong direction given underlying fundamentals. As it turns out, very few Fund Managers outperformed the benchmark after fees over the last 6 months. Each year we set ourselves a target of outperforming the market after fees by 5% with a stretch target of 10%. We are happy that we were able to achieve in the middle of this range with total alpha of 7.24% for the 12 months ended May 2014. The Fund's volatility (2.89%; standard deviation of monthly returns) was slightly higher than the benchmark index (2.67%) despite the concentrated nature of the portfolio. Generally, volatility of the Fund is expected to be higher than the benchmark index. Investors can monitor our performance over coming periods by accessing the APSEC Funds Management website.

Investments

In the table below, the main contributors and detractors to performance are highlighted categorised by market capitalisation bands.

Significant Contributors (>1%)		
ANZ	ANZ Banking Group	Large (>$5.5B)
CGF	Challenger	Large (>$5.5B)
FMG	Fortescue Metals	Large (>$5.5B)
JBH	JB Hifi	Mid (>$400m)
LLC	Lend Lease	Large (>$5.5B)
PMV	Premier Investments	Mid (>$400m)
SEK	Seek	Large (>$5.5B)
SGH	slater & Gordon	Mid (>$400m)
TGR	Tassal Group	Mid (>$400m)
TLS	Telstra	Large (>$5.5B)
Significant Detractors (<-0.25%)		
CCV	Cash Converters	Mid ($400m-$5.5B)
CRZ	Car Sales	Mid ($400m-$5.5B)
DTL	Data#3	Small ($100-$400m)
FGE	Forge Group	Mid ($400m-$5.5B)
FLT	Flight Centre	Mid ($400m-$5.5B)
ILU	Iluka Minerals	Mid ($400m-$5.5B)
MTS	Metcash	Mid ($400m-$5.5B)
QBE	QBE Insurance	Large (>$5.5B)

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In the large company space, which contributed over 60% of the Fund's returns, we successfully selected outperforming companies including Challenger Financial (CGF), Fortescue Metals (FMG) and Lend Lease (LLC). In each case, the investment case was somewhat contrarian to the rest of the market at the time we invested and our homework resulted in very good returns. We generally prefer to accumulate when others are selling and together with our price entry disciplines, should yield superior results over time. Our other performing large company exposures included ANZ Banking Group (ANZ) and Telstra (TLS), offering a yield-ballast to the portfolio. In the mid-sized company space, which contributed around a third of the Funds returns, exposures to JB Hi-Fi (JBH), Premier Investments (PMV), Slater & Gordon (SGH) and Tassal Group (TGR) yielded strong results. Once again, these investments were somewhat contrarian to market expectations. At the time of entering each of these positions, we had a smorgasbord of mid-sized company opportunities. We chose companies that were much cheaper than the market with suitable liquidity which had the potential to re-rate over the coming years. In each case, resulting price performance was very strong driven by both strong positive earnings revisions and valuation expansion.

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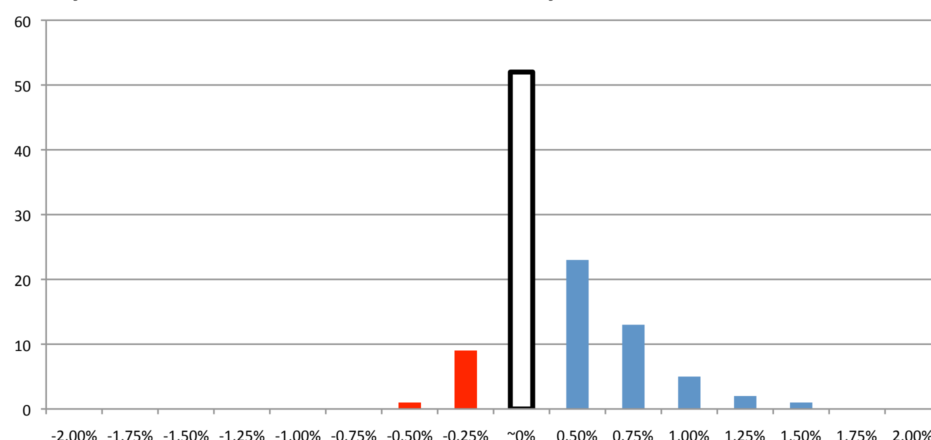
We now turn to the negative contributors. Quite clearly our biggest mistake or most unfortunate incident over the year was the Fund's investment in Forge Group (FGE). The company is now in liquidation and has been completely written-off within the Fund's accounts. The Responsible Entity (One Managed Investment Funds Limited) on behalf of the Fund's unit-holders is participating in a class action against the directors of Forge Group. We are still baffled as to how this occurred. We were certainly of the view at the time that their forward dynamics were improving based on company releases. However, the extent to which they had under-reported earnings in their Power business was nothing short of spectacular. This event was truly humbling and we apologise for this. QBE Insurance (QBE) was also an instance of where our investment thesis turned out to be wrong.

Sensitivity to downside risk management due to heightened global risk is a central feature of our process

We had expected the company to report stronger earnings in light of a steepening yield curve translating into higher discount rates for their liabilities and higher yields on their investment balances. Unfortunately, the transitional movement to higher interest rates, particularly in the US, did not lead to the leverage we were expecting. In addition, the company reported further extraordinary provisions which brought into question management's credibility. The Fund's position was sold the same day this information was released to the market.

Having made good returns from stock selection in the first half of the year, the second half of the year presented as more risky than the first. This risk stemmed from multiple macro-economic events (both anticipated and not) which resulted in lower market exposure. At times when the Fund had lower equity exposure, the market unexpectedly rallied. We estimate the foregone returns or opportunity cost for the Fund was approximately 2% from lower market exposure over this period. This sensitivity to downside risk management due to heightened global risk is a central feature of our process. In the chart below, it highlights the Fund's relative performance on down days to its benchmark. Over the year there were approximately 100 down days. Of these, only 10% of the Fund's negative daily returns underperformed by over 0.25%. In other words, there is an observable skew to the right confirming the Fund tends to lose less money on down days. We believe this to be an important attribute of the Fund's investment profile considering on a daily basis there is a relatively high proportion of down days.



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Future Dynamics

Corporate Earnings - Australian listed companies have reported strongly over the past 12 months despite the obvious issues with the slowing mining industry. We expect if the Australian economy washes off to some extent the west-coast slowdown by an east-coast resurgence, then Australian corporate earnings will continue to perform well. The only caveat is the impact on the consumer from the recent Federal Budget. We don't believe this will be too contractionary over the medium term and recent weakness in consumer confidence is likely to be short-lived. However, we recognise that other investors, particularly international, may view each of these events in the completely opposite way and may lead to underperformance of Australian equities relative to other major developed markets. We remain wary of these developments. Corporate America has also reported strongly over the past 12 months. This has been in an environment of an improving domestic economy and a weakening dollar against the Euro. This has supported upward revisions for a large segment of their market, given the proportion of multi-nationals in the US. Over the past quarter though, the US dollar has strengthened against the Euro (due in part to the relative expected change in monetary policy between these very large trading blocs) and may lead to downside earnings surprise for US multi-national companies. Otherwise, US domestic companies appear to be operating well driven by the natural leverage of an improving economy.

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Valuations at a market level are fair and are in no way stretched relative to history over the past 20 years. In order for prices to be supported at current levels, continued positive earnings momentum through the next Australian reporting period in August 2014 will be required. There was much conjecture prior to the February reporting season whether earnings would improve relative to expectations. This indeed occurred and we hope this continues over the medium term.

Compared to other major economic zones across the world, the Chinese economy presents as the most likely to surprise on the downside over the coming year.

Over the past quarter financial services related names (accounting for over 40% of the Australian market's capitalisation) have reported well. More recently, there have been a number of companies that have downgraded guidance in the consumer discretionary space. In most cases, these downgrades are a continuation of structural issues these companies have faced over the past year or so which we have avoided. Further, these companies are only a small part of the Australian equity market and do not generally infer across-the-board downgrades. On the resources front, those companies exposed to Iron Ore (accounting for just over 10% of the Australian market's capitalisation) will remain in downgrade mode for the foreseeable future. However, they are currently either cheap on a cycle forward valuation perspective or from the perspective of market analyst long run discounted cash flow models.

Compared to other major economic zones across the world, the Chinese economy presents as the most likely to surprise on the downside over the coming year. This is obviously important for Australian Investors. For many years, the mooted Chinese slowdown has been spoken of for many years driven by an expected reversal in unrelenting fixed asset investment over many decades in conjunction with an opaque internal funding model. More recently, Chinese property and investment in heavy industry has been slowing materially over the past 6 months. This has been due to restrictive credit policies over the past 12 months finally having an impact. The Chinese Politburo have recognised structural issues and have tailored policies aimed at sectors which exhibit over capacity together with their earnest efforts to repair the negative environmental costs of heavy industry. This new policy slant will generally not bode well for Australian companies exposed to the growth in global steel markets particularly those companies that mine Iron Ore. These companies are also exposed to a significant increase in the global supply of Iron ore, much of their own doing, which has resulted in very weak iron ore prices over the past quarter. As any student of history may know, reviewing investment cycles of other great industrial nations (eg US, Japan) saw significant volatility due to booms and busts. China is no different despite their greater ability to manage cycles due to their "command economy". In part, the central driver of overcapacity in other nations was easy credit. Similarly, China has undergone an enormous credit boom and the fallout in key industries cannot be protected despite calls for further stimulus. We suspect a series of credit events, as has occurred in other economies, will herald further downside volatility for the Chinese economy, though timing will be hard to predict.

In Summary

Our focus on generating upside volatility while minimising downside volatility within the large and mid-cap space has played out over the past year. As is always, we need to be consistent with the way we approach equity markets and believe over the long term (5-7 years) our strategy will generate significant excess returns for investors. We thank all current investors for their trust in us in managing part of their investment portfolio and look forward to continuing to serve you over the coming years. We would also like to take this opportunity to thank all service providers of the Fund who have assisted us in delivering a robust operational and compliant platform for unit holders.

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