King Tide Investor Up-date
January 2017

2015 and 2016 have been two very different years in terms of performance for King Tide. In 2015 we had an exceptional year, making 29% in a market which rose just 7%. Results in 2016 were at the other end of the spectrum, with a fall of -8% in a market which rose 9%.

Put together, the two years show an 18% gain versus the market's 16%, with around 2/3rds of the volatility. Over three years King Tide has risen 28%, more than 8% better than its NZ/Australian equity benchmark, and again, this has been achieved with about 2/3rds the volatility.

Human psychology being what it is, will tend to forget the gains of 2015 in light of the losses in 2016. The very strong returns in 2015 attracted new investors and for our new investors, the results of the last few months have no doubt been below their expectations. When returns disappoint, questions naturally arise. Have the managers chosen the wrong funds, or is the strategy no longer valid, or is the market maturing and the returns of the past no longer available.

In this report, we endeavour to show that the losses of the past year are a normal part of the territory for truly active managers, who totally ignore market indices when selecting their portfolios. With managers whose portfolios bear no resemblance to the underlying market (as measured by market indices), we should not expect the return stream to be similar. The fact is, that if the return profile of a fund is closely aligned with the markets in which it operates, the chances of significant outperformance over time is limited.

Howard Marks, one of the world's most successful investors, writes in his book, "The Most Important Thing Illuminated"

"Every investor who's unwilling to throw in the towel on outperformance, and who chooses to deviate from the index in its pursuit, will have periods of significant underperformance. In fact, since many of the best investors stick most strongly to their approach-and since no approach will work all the time-the best investors can have some of the greatest periods of underperformance"

Commenting on this paragraph, Joel Greenblat, author of "The little book that beats the market", writes:
"In the decade of the 2000's, 79 percent of the investment managers who ended up in the top quartile of performance spent at least three years in the bottom quartile (source: Davis Advisors). Most investors chase the hot fund and don't stick with managers who underperform over the short term."

If you examine King Tide's returns over the last three years the average divergence between the Fund and the benchmark has been 14% p.a. This can be uncomfortable for investors used to more traditional equity exposures which move more or less in line with equity markets. Studies show that the joy of making an outsize return is far less than the pain and discomfort of making a poor return. Truly active management returns will not be comfortable and is the reason so few investors stay the course.

But what of our claim to protect the downside, to always be carrying our umbrella. When a fund drops 8% in a year, is this claim still valid?

We think it is. If you examine our returns, there is only one predictable pattern, and that is, when markets fall, our losses are much less, and when they fall heavily, they are less again.

Since our inception, on the fourteen occasions the market has fallen more than 2.0%, with an average loss of -4.0%, we have outperformed in every one of those months, with an average loss of -1.6..

There have been seven months when the market has fallen more than -4%, with an average fall of -5.1%. We have fallen less in all seven months with an average fall of just -1.4%!

The reason this is important, is that one day the market will fall a lot, and no-one knows when that will be.

There are a few factors underlying our 2016 results. One was the severe short squeeze in February/March on the back of China intervention to stimulate commodity prices and settle their share market which was in free-fall. This resulted in a rally in commodity related stocks, funded by the sale of 2015's best performing, high quality but high PE growth stocks. Most active managers, including a number of ours, were caught on the long and the short side of this.

This was the beginning of a rally in resource stocks in the Australian market, which saw the sector rise 42.9% for the year. The Small Ordinaries Resources Index was up 57.8% versus the Small Ordinary Industrial's +2.3%. A number of our managers do not invest in resource stocks, given their cyclical nature and the difficulty of forecasting commodity prices. Further, some of those who do invest in resource stocks have been largely unconvinced the commodity rally in coal and iron ore is sustainable, and have continued to play this sector from the short side which has hurt them.

In the fourth quarter, our worst by far, in which we lost -7% versus the market's +2%, we have seen a move out of mid to small companies back into large cap, principally into banks and resources on the back of the "Trump rally". Financial stocks rose 11% in the fourth quarter versus a fall of -2.9% for the Small ordinaries.

Bell Potter's Richard Coppleson wrote in his final report to clients before Christmas. *"Talk to any small-cap manager and they will tell you they have seen hell for the first time in years,"*

Geoff Wilson from Wilson Asset Management (a KT fund), said the "herd mentality" stampede by large-cap investors into small caps had left the index significantly overvalued.

"It was the trendy thing to do from an investor perspective, to go into small caps," Mr Wilson said.

"We have had that adjustment in the past three months. It is all logical what has happened. But when the larger guys reallocate, it is quite brutal".

Centennial Asset Management's Matthew Kidman (a fund KT are adding when we re-open) said many valuations specifically in the "small-cap industrial finance space" were stretched four months ago. He labelled the recent rotation as *"the silent crash".*

"Money has been coming out of that space through redemptions, rotations or policy changes on mandates and that is killing valuations. But over the long run it will provide opportunities for investors in this space," Mr Kidman said.

A number of King Tide managers have limited exposure to the largest companies in Australia, and a higher weighting to small and mid-caps, so were negatively impacted by this rotation. (roughly 30% of KT managers are mainly small cap)

Coming back to Howard Mark's comments on managers staying the course, we have seen this across a number of our funds this year, who continue to hold companies which have been sold off and are short companies which have been bid up.

We are making some adjustments to the way we weight various managers and to timing of our investments, but our fundamental management selection process and thinking is largely unchanged. We aim to select talented managers who focus on their own unique strategies which will always include a stated acknowledgement of the importance of 'not losing capital'.

Secondly, we accept certain strategies which are concentrated and some which use leverage, and we accept these strategies can create short term losses, but also believe, if practiced by experienced, gifted and disciplined managers, will produce the best returns over time.

Thank you for entrusting us with your capital. We take this very seriously and as you know, we too are significant investors in the Fund. All of our underlying managers are likewise, significant investors in their funds, and this alignment of interest is important to us and I'm sure to you also.

We look forward to recovering this year's losses and moving on to new highs in the months and years ahead.

Best regards
Mark Houghton