



PARAGON AUSTRALIAN LONG SHORT FUND // February 2018

PERFORMANCE SUMMARY *(after fees)*

	1 month	3 months	6 months	Financial YTD	1 year	2 year p.a.	3 year p.a.	5 year p.a.	Net Return p.a.	Total Net Return
Paragon Aust. Long Short Fund	-3.0%	+0.2%	+36.8%	+46.5%	+41.9%	+24.9%	+17.2%	+18.8%	+18.8%	+136.5%
ASX All Ordinaries Accum. Index	+0.2%	+3.6%	+8.9%	+9.1%	+13.1%	+15.9%	+8.0%	+8.1%	+8.1%	+47.9%
RBA Cash Rate	+0.1%	+0.4%	+0.8%	+0.9%	+1.5%	+1.6%	+1.8%	+2.1%	+2.1%	+10.9%

RISK METRICS

Sharpe Ratio	1.0
Sortino Ratio	1.9
Correlation	0.4
% Positive Months	+68%
Up/Down Capture	+104% / +17%

UNIT PRICE & FUM

NAV	\$2.2262
Entry Price	\$2.2295
Exit Price	\$2.2228
Fund Size	\$78.1m
APIR Code	PGF0001AU

FUND STRATEGY

Established in March 2013 as an Australian equities long/short fund that is fundamentally driven with a concentrated portfolio of high conviction stocks, managed by a dedicated investment team and offering transparency to investors. Paragon's proprietary research and extensive investment process which includes active portfolio management, is overlaid with a strong risk management function and a focus on capital preservation. The objective of the Fund is to return in excess of 10% p.a. after fees over a 3-5yr investment horizon.

OVERVIEW & POSITIONING

The Fund returned -3.0% after fees for the month of February. Since inception (March 2013) the Fund has returned +136.5% after fees vs. the market +47.9%.

Positive contributions in the month were from Global Geoscience and our shorts in Invocare, IPH, Ramsay Health (all downgrading), IOOF, Telstra and our bond proxies. These were more than offset by declines in Orocobre, CleanTeq, Challenger, Janus Henderson, Agrimin and Echo.

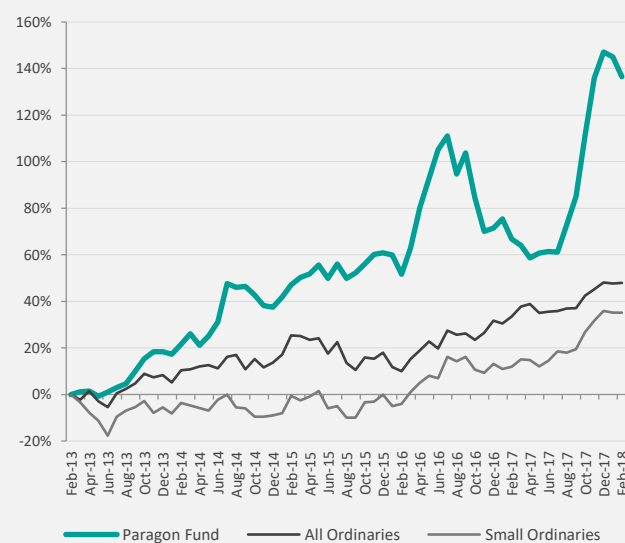
FUND POSITIONING

Number of Longs	32
Number of Shorts	19
Net exposure	72.8%
Gross exposure	137.0%
Index futures	0%
Cash	27.2%

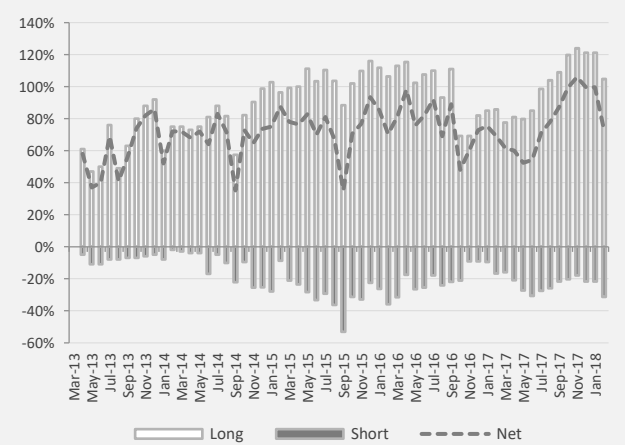
FUND FACTS

Structure	Unit trust
Domicile	Australia
Applications & Redemptions	Daily
Minimum investment	\$25,000
Min. addition/redemptions	\$5,000/\$10,000
Administrator	Link Fund Solutions
Prime Broker/Custodian	UBS

HISTORICAL PERFORMANCE *(after fees)*



HISTORICAL EXPOSURE



MONTHLY PERFORMANCE BY CALENDAR YEAR

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
2013			1.1%	0.3%	-2.2%	1.8%	1.8%	1.6%	5.3%	4.9%	2.8%	0.0%	18.7%
2014	-1.1%	3.8%	3.6%	-3.9%	3.2%	4.9%	12.5%	-1.1%	0.3%	-2.5%	-3.1%	-0.5%	15.9%
2015	3.2%	3.6%	2.1%	1.1%	2.4%	-3.8%	4.3%	-4.2%	1.6%	2.5%	2.6%	0.3%	16.8%
2016	-0.5%	-5.2%	7.4%	10.8%	7.0%	6.3%	2.9%	-7.8%	4.3%	-9.0%	-7.9%	0.8%	6.8%
2017	2.3%	-5.0%	-1.6%	-3.2%	1.3%	0.4%	-0.2%	7.3%	7.0%	14.0%	11.9%	4.7%	44.1%
2018	-1.3%	-3.0%											-4.3%

Performance results are presented net of all transaction costs, investment management and performance fees incurred by the Fund. Monthly performance figures are calculated based on the lead series, using a daily unit pricing methodology based on historical data.



The return of volatility to global markets

In 2017, despite a noticeable reduction in global central bank asset purchases, strong growth and impending US tax cuts, long term US 10yr bond rates did not rise and finished the year largely unchanged at ~2.4%. US equity markets saw positive gains in every month of 2017, +30% for the Dow and volatility at record lows. The start of 2018 has seen a rapid sell-off of bonds with the 10yr bond rate up to ~2.9%, triggering high volatility and a ~12% correction in US stock markets – the first >10% correction in two years. The current correction is well and truly overdue and markets have since recovered around half their losses. We believe that rising bond rates and their rate of change will continue to drive increased volatility over 2018. Continued strong global growth may force central bank cash rate increases, due to resurgent US wages and increasing inflation. Additionally, with global central banks looking to progressively unwind their quantitative easing programs, the global mood has swiftly moved from greed to fear.

It is fair to say that several of our key high-conviction long positions, which have exhibited strong outlooks and valuation support, also carry higher volatility in periods of market stress. Investors should note however that overall these stocks have been outstanding performers for the Fund. Similarly, it is important to remember that Paragon has a flexible mandate and is active with its exposure, having the ability to hedge and shift to a higher cash position (currently 35%) when appropriate.

Portfolio highlights

February's reporting season saw the Fund's long and short positions deliver half year profit results as anticipated. However, the Fund's performance was down for the month as a result of the sudden correction in global markets and the ongoing oversupply anxiety in Lithium impacting our Electric Vehicle (EV) thematic stocks (as discussed last month). Pleasingly, our key long positions confirmed production/profit and outlook statements, or otherwise announced positive catalysts whilst importantly, we avoided being long any of the 'blow-ups' (ie. well-held stocks announcing downgrades). Furthermore, we also held short positions in several stocks that announced downgrades, which consequently resulted in positive contributions for the month. Below we provide an update on each of these stocks:

Invocare (IVC) – Short. Invocare has long been a market darling and popular small cap stock. Since its IPO it has delivered strong returns as it rolled-up the Australian funeral sector. Over this 15-year period, the company has grown to over 30% of the industry, whilst it has branched out to NZ, Singapore and a short (and failed) attempt in the US. Despite the company's success, we believe Invocare has been losing its lustre more recently, as it succumbs to a number of challenges: 1) changing consumer preferences; 2) greater price transparency (Invocare brands typically rank amongst the most expensive); and 3) increased competition. In order to meet these challenges, Invocare has embarked on a three-year \$200m capital program (named Protect and Grow) to refresh their brands, facilities and organisational/operating structure. To fund this, the company is using debt and tapping out its balance sheet in the process (noting that the FY17 report was the first of many where Invocare highlighted the prospect of raising equity to fund acquisitions). We established a short position (at ~25x operational earnings) in early February leading into the FY17 results. These challenges have become more evident - another negative volume and market share loss in a market that grows steadily each year, as well as heightened marketing spend against an increasing competitive threat. In addition, Invocare delivered a negative surprise guiding to marginal EBITDA growth and zero earnings growth. We believe the challenges facing the

company will persist over many years and that during this time, the multiple afforded to an incumbent laggard in an increasingly competitive sector will reduce.

IPH Limited (IPH) – Short. IPH was the first of three patent and trade mark law firms to list on the ASX between 2014 and 2016. Over this period, it has generally been another poor experience for investors in professional services firms. All three companies (IPH, Qantm and Xenith) listed on the basis that intellectual property work was a steady growing and stable 'cash cow'. However, this was when these companies were in a position to roll up the sector in Australia and buy growth in Asia where patent and trade mark volumes have been growing strongly. In February, IPH reported a material negative surprise with earnings declining ~11% compared to the prior period, despite top line growth of ~9% (via acquisition). A far cry from the steady growing 'cash cow' promised to investors. The company struggled with a continuation of negative volume growth (-2%) in Australia (~66% of revenues), which resulted in a leveraged revenue decline (-5% pcp), with the bottom line experiencing smaller declines due to one-off cost cutting. Our fundamental research included speaking to various industry contacts and has led us to conclude that the sector is more cyclical than it appears. We believe that the sector is facing a range of headwinds, which could have a further negative impact on earnings. We believe IPH is ex-growth and at risk of materially downgrading again. IPH's weak paper all but precludes it from making acquisitions (hampering their only remaining growth driver). We continue to remain short the stock despite the relatively low headline price earnings multiple.

Updater (UPD) - Long. We last wrote about Updater in [July 2017](#). Updater continues to progress well towards its long-term market penetration target of 35%, which would reinforce Updater's aim to be a complete platform for the relocation process. CY18 will be the first step towards commercialising the platform, with two paid product verticals being launched at the end of 4Q CY17. We expect a third vertical to launch within the half (by year end the company expects to have five verticals launched). On the back of reporting their FY17 results, Updater provided formal revenue guidance of US\$19m to US\$23m for CY18. With many material and value-adding catalysts ahead, we remain long in the stock.

IOOF (IFL) – Short. As evidenced in IOOF's 1H18 result, margin pressure in the advice and platform segments continue to constrain revenue growth with cost control helping the group for now. The structural shift from large incumbent wealth managers to independent advisers with preferred technology offerings is going to remain an ongoing headwind for the company. IOOF's expensive acquisition of ANZ Wealth compounds risks around margins, flows and falling adviser numbers. We believe revenue margin pressure will continue at a faster rate than IOOF can cut costs. Our view is that market expectations are too high and we maintain our short position.

Ramsay Healthcare (RHC) – Short. Ramsay reported a low quality 1H18 result and moderately missed both revenue and EBITDA expectations. Ramsay joined the '2H-club', in guiding for improvements in the second half of the financial year. While some operating tailwinds improve in 2H18, growth is likely to again be low quality. We believe the stock is expensive given its cloudy earnings outlook and we continue to hold a short position.

Smartgroup (SIQ) - Long. We wrote about Smartgroup in [July 2016](#) and [August 2017](#). Smartgroup announced yet another strong set of results for CY17, driven by ongoing organic growth and acquisitions. Smartgroup continues to be a very well-run business with a conservative balance sheet. Management are tier 1, delivering strong EBIT margins and double-digit



earnings growth. We remain long the stock and expect a premium rating on growing earnings to drive its upside.

Telstra (TLS) – Short. We initiated a short position in Telstra at \$4.83/sh in February 2017, premised on rising mobile & broadband competition which was likely to impact on Telstra's growth outlook. (We wrote about Telstra in [April 2017](#) and [August 2017](#)). Underlying core 1H18 earnings weakened again as the risks in mobiles continue to play out to the downside, with the average revenue per user and margins deteriorating. We continue to see Telstra's dividend at risk and remain short on the stock. Additionally, rising 10-yr bond rates is a double-whammy for Telstra which we also view as a bond-proxy.

EV thematic stocks. ORE was sold off due to ongoing Lithium oversupply concerns. Various companies released overly optimistic new supply ambitions, while Morgan Stanley's bearish sector views in its recent note created selling pressure across the sector. While we keep an open mind to constructive views, it does feel a bit like 'ground-hog day'.

Sadly, it appears the market continues to react to biased research from sell-side research houses (who have missed the lithium bull market), and 'chest-beating' companies talking very big games on their expansion plans, despite their poor execution track records. The potential for oversupply is at best two years away. In any case, when oversupply eventuates, lithium prices will be supported by the marginal cash cost of production. We estimate this to be ~US\$10,000/t and in the interest of conservatism, we use this as our lithium price in all our stock base-case valuation modelling.

CLQ was down as it announced a three-month delay in reaching its project feasibility, with increases in its capex to be expected premised on project scope additions. Capex increases are likely to be covered by the increase in cobalt and nickel prices and production increases.

Global GeoScience (GSC) - Long. We wrote about Global in [August 2017](#). Global Geoscience's Rhyolite Ridge project technical milestones continue to surprise to the upside. In February, the company announced its optimisation success - reducing leach processing times by 60% whilst maintaining excellent lithium and boron recoveries. Rhyolite Ridge is the only lithium deposit in the world that has demonstrated to be amenable to simple acid leach processing. With its boron by-product credits, Rhyolite Ridge is likely to be the lowest cost Lithium producer in the world. We expect its pre-feasibility study due at the end of 2Q18 to prove its status as a highly strategic world class asset. Also noteworthy is that the lithium oversupply concerns did not impact Global which performed strongly in February, up ~30%. While Global is up >4x on our cost base, we still see strong upside potential in the stock.

Paragon Team update

Tracy Brown joins Paragon as Head of Distribution on 19 February

We were pleased to announce the appointment of Tracy Brown as Head of Distribution in the month of February.

In this role, Tracy is responsible for developing and executing the overall distribution and marketing strategy for Paragon, and in particular, will be integral in driving Fund growth, whilst enabling the investment team to dedicate themselves to continue delivering on the Fund's investment objective.

With over 20 years' financial services experience, including over a decade with Colonial First State, we are delighted to have someone of Tracy's calibre joining our team.

Paragon Australian Long Short Fund – 5 year anniversary

It would be remiss of us not to highlight this significant milestone. The Fund has achieved an annualised return of +18.8% for the 5-year period, which is almost double the investment objective of > 10% and more than double the markets 8.1%. We look forward to continuing to deliver for another five years and beyond, updating investors along the way with our progress.