PARAGON FUNDS MANAGEMENT

THE PARAGON FUND // JANUARY 2016

PERFORMANCE SUMMARY *(after fees)*

	1 month	3 month	6 month	1 year	Financial YTD	Net Return p.a.	Total Net Return
Paragon Fund	-0.5%	+2.5%	+2.3%	+12.6%	+6.7%	+17.4%	+59.8%
ASX All Ordinaries Acc.	-5.4%	-3.6%	-8.8%	-4.7%	-5.0%	+3.9%	+11.7%
RBA Cash Rate	+0.2%	+0.5%	+1.0%	+2.2%	+1.2%	+2.4 %	+7.1%

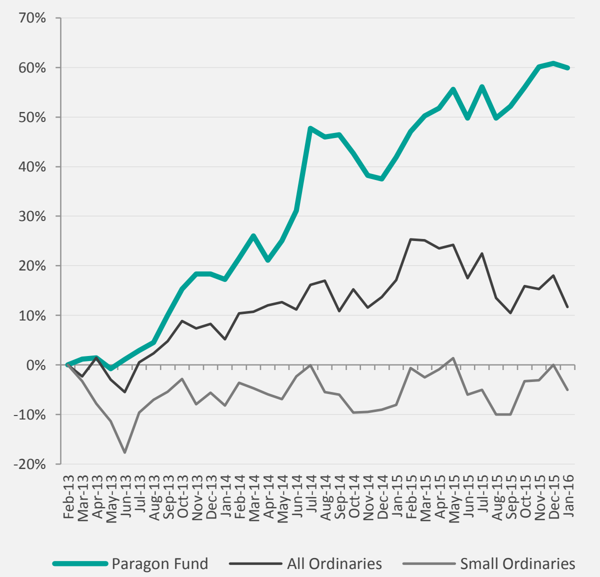
RISK METRICS

Sharp Ratio	1.3
Sortino Ratio	2.8
Volatility p.a.	+11.5%
% Positive Months	+73.5%
Up/Down Capture	79% / -14%

FUND DETAILS

NAV	$1.5043
Entry Price	$1.5065
Exit Price	$1.5020
Fund Size	$37.1m
APIR Code	PGF0001AU

HISTORICAL PERFORMANCE *(after fees)*



FUND STRATEGY

The Paragon Fund is an Australian equities long/short fund established in March 2013. The Fund's strategy is fundamentally driven, concentrated and transparent for investors. The manager's research process and active portfolio management is overlaid with strong risk management and a focus on capital preservation.

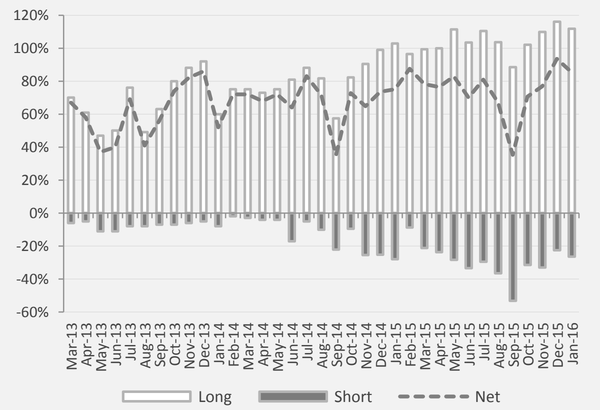
The objective of the Paragon Fund is to return in excess of 10% p.a. after fees over a 3-5yr investment horizon.

OVERVIEW & POSITIONING

The Paragon Fund returned -0.5% after fees for the month of January 2016. Since inception the Fund has returned +59.8% after fees vs. the market (All Ordinaries Accumulation Index) +11.7%.

Key positive contributors for January included Longs in Amaysim, Blackham Resources, our lithium holdings (Orocobre & General Mining), and shorts in Magellan, Select Harvest and the energy sector. At the end of the month the Fund had 34 long positions and 14 short positions.

HISTORICAL EXPOSURE



INDUSTRY EXPOSURE	Long	Short	Net
Resources	+34.2%	-8.0%	26.1%
Industrials	+67.6%	-18.4%	49.2%
Financials	+9.5%	0.0%	9.5%
Total	**+111.3%**	**-26.4%**	**84.9%**
Cash			**15.1%**

MONTHLY PERFORMANCE BY 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%												**-0.5%**

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 monthly unit pricing methodology based on historical data.

OUTLOOK

In our December 2014 and January 2015 monthlies, we outlined a fairly muted prospect for equity markets in the year ahead. Global growth was slowing, led by China, and we were coming to the end of the US great experiment with Quantitative Easing. The negative impact the rising dollar would have on US earnings forecasts meant we were cautious about the global equity markets' ability to continue to rise as liquidity tightened. As such we expected Australia to do relatively well given its high level of dividends. The annual returns for global markets in 2015 bore out this environment, with the WORLD MSCI Index falling 4% and Australia rising 2% (inc. dividends). Our focus on companies that can grow through the cycle due to structural tailwinds saw the Paragon Fund rise 16.8%.

The beginning of 2016 has been a jolt to all those with sand still between their toes. The first two weeks of this year produced the poorest global equity market returns on record, continuing the trend of softer equity markets since the middle of last year. China is in an official bear market, as is the broader US equity market (Russell 2000), while the Nasdaq and the market leading FANG'S (Facebook, Apple, Netflix, Google) posted their worst returns in January since the onset of the GFC. Europe, Japan and Australian equity markets also breached technical bear market levels (-20% from peak) during the month. For us there stands 3 clear issues weighing on investor sentiment – Oil, China, and the US economy.

The main near term driver of the market's woes today is the state of the **oil market** and the debt of companies exposed to the industry. Years of low interest rates forced corporates to shift up the risk curve to seek returns and financial stocks globally have suffered heavily this year due to uncertainty surrounding the high level of shale oil funding over the last five years. With several high profile US credit funds overexposed to the energy sector closing their doors recently, there has been a heavy focus in the recent US bank conference calls on their exposure to the energy sector. Clearly the risks lie further afield than the already junk rated US oil exploration companies. Standard&Poors estimate that corporate Debt to EBITDA reached 3 times in 2015, the highest level of leverage in over a decade. According to UBS, the investment grade credit market has doubled to over $4tn since 2009, of which over 40% is BBB non-financial credit which is most exposed to downgrade risk, additional forced selling by managers not able to hold junk rated paper, and significantly higher borrowing costs.

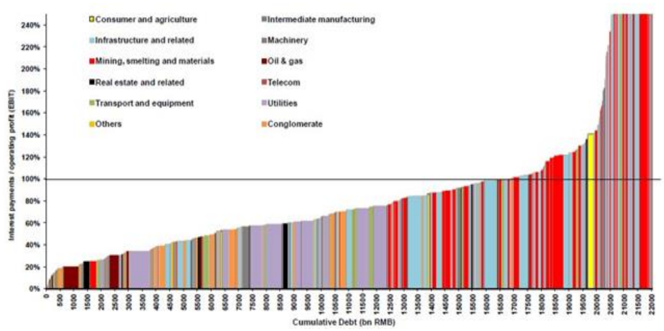
US High-Yield Bond Yields

Source: CLSA, Datastream, Barclays

The prospect of a sustained low oil environment, now more likely with the removal of Iranian export sanctions, could impede the credit market's ability to properly function amidst bankruptcies and corporate stress amongst leveraged oil companies and exposed lenders. The risk is that in such an escalating environment, the impact flows into the broader market creating a continued search for safe haven assets and aversion to risk.

China's economy has been slowing for several years yet one of the triggers for this year's rout appears to be the weak economic data in early January. Indeed last year's selloff in August coincided with the devaluation of the RMB in an attempt to make Chinese exports more competitive (the RMB was pegged to the USD which had risen some 60% against China over the last decade). The reaction in risk assets to this managed devaluation suggests the most widely held belief is that China is being forced to devalue its currency in an attempt to revive a waning economy. China's economic growth continues to suffer from deflationary forces, with GDP growth hitting a 25 year low, as it transitions away from manufacturing to a services based economy (CPI rose 1.4% in 2015 – lowest in 6 years; while the PPI has been printing negative for almost 4 years). This is of course despite a banking system that has seen total debt exceed GDP by ~3x , led by loans to the property market. The clear risk to a bullish view on China is that as growth decelerates, China gets deeper into a bad debt cycle. While officially China states that the non performing loan ratio is 1.8%, CLSA suggest its closer to 8% and Macquarie estimates that already one quarter of Chinese firms with debt are unable to cover their interest expense.

China's Cumulative Debt Coverage at 780 bond issuers (EBIT basis, 2014)

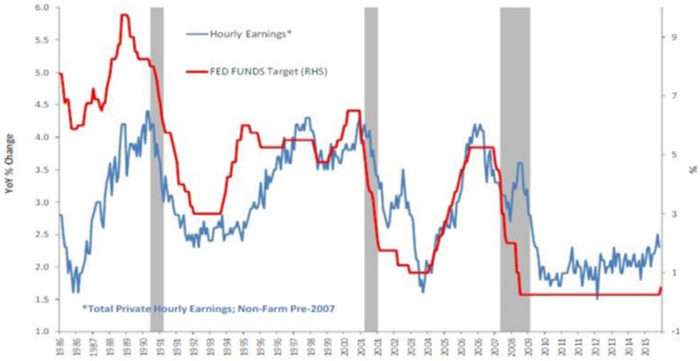


Source: Wind, Macquarie

This could go some way to highlighting why China's balance sheet expansion to date hasn't led to better growth – the banking system has been using the capital to plug holes. Several bungled attempts by the Chinese authorities to impose calm in their financial markets and prevent accelerating capital outflows has only amplified investor unease and we continue to see China posing the largest medium term risk for global markets.

US economic growth meanwhile, continues to wane under the impact of a strong dollar and slowing global growth. Much to the disappointment of the Fed, after more than half a decade of Quantitave Easing, the US economy is managing to grow only +0.4% above what most have long considered the problem child of the developed world, Europe. Economic indicators are close to levels that historically precede a recession (an ISM reading of 45 or less has led to a recession in 11/13 occasions over the last 70 years). Rail volumes in the US are already at recessionary levels, global freight has turned negative, and commodities are posting the worst 10 year rolling returns since the great depression. While manufacturing and goods producing industries account for much less than a quarter of the US GDP, they represent a much more significant part of US corporate profits. Seemingly counterintuitively, the ongoing strength of the labour market has set the Fed on a path of Quantitative Tightening, having raised rates for the first time in a decade.

US Wages Growth vs. the Fed Funds Rate (1986-2015)



Source: Doubleline, Bloomberg

This long telegraphed event and continued central bank easing in Europe and Japan has propelled the US Dollar higher, negatively impacting the ~50% of US earnings that are generated offshore by US multinationals. Given the part the USD has played in all of the above issues, any further significant increases in the USD will heighten the associated risks and its direction could indeed be the biggest indicator to watch for this year.

Despite the bad start to 2016, we believe markets are merely testing the lower bounds of their ranges and are likely to continue to stay volatile until clarity on one or more of the above issues can be achieved. We would expect that if China and the US economies do muddle through, then stocks will remain relatively well supported assuming high yield debt market problems casued by low oil prices don't spill over to the credit market as a whole. Indeed the fact that oil is a depleting asset means that at some point, oil will begin to rise again as production cuts begin to reduce global inventories.

For now, economic growth in Europe, Japan and Asia remains reasonable while China, although slowing, continues to grow at a solid clip. Interest rates globally remain supportive regardless of whether the Fed raises two or four times in 2016 with corporate borrowing costs still almost a third of their long term average in the United States. Falling oil prices have reduced inflationary pressures and created a boon for the oil importing nations of the UK, Europe and Asia. Although the positive impact of cheaper oil on the US consumer is somewhat mitigated by rising healthcare costs, it should still enable the US economy to escape an all-out recession. In fact returns in US equities post the last four major oil market crashes, of which the current is the most severe, have delivered significant double digit returns the year after as the wealth effect from lower oil feeds into consumers' pockets.

As such, we are embracing the fact that companies we are fundamentally attracted to are cheaper than what they were several months ago. The global forces weighing on the markets will do little to stop the sheer size of the Chinese middle class increasing, stymie the rising number of devices connected to the internet, or stop the increasing demand for electric vehicles. As has been the case since our inception, this remains a good environment for active managers with the flexibility to hold high levels of cash which can be deployed as the market swings between optimism and pessimism.