Dear investors,

This letter will cover the Fund since inception, from June 14 to July 31, 2016.

Performance

On June 14 I launched the strategies I've been operating since July 1, 2013. Brexit occurred shortly after, so perhaps this timing was not ideal. By the end of June the Fund was down 2.5%, after crystallising a 5% loss in a GBP funded position in UK equities

Pleasingly the Fund made back the losses and more, ending up 5.4% net of fees in July for a total return since inception of 2.75%. Across all accounts we have approximately A$1.5 million under management.

We were happy with this performance as we were hedged aggressively but these trades still cost over four percentage points of performance.

Macro

We are in a strange market environment. For years now, adverse events have led to *higher* US equity valuations, as central bankers used a range of excuses to keep rates low. Most hedge funds, generally a bearish bunch, have struggled to generate any positive returns, let alone alpha. This can be rationalised by lower rates translating directly into lower equity discount rates and rising markets.

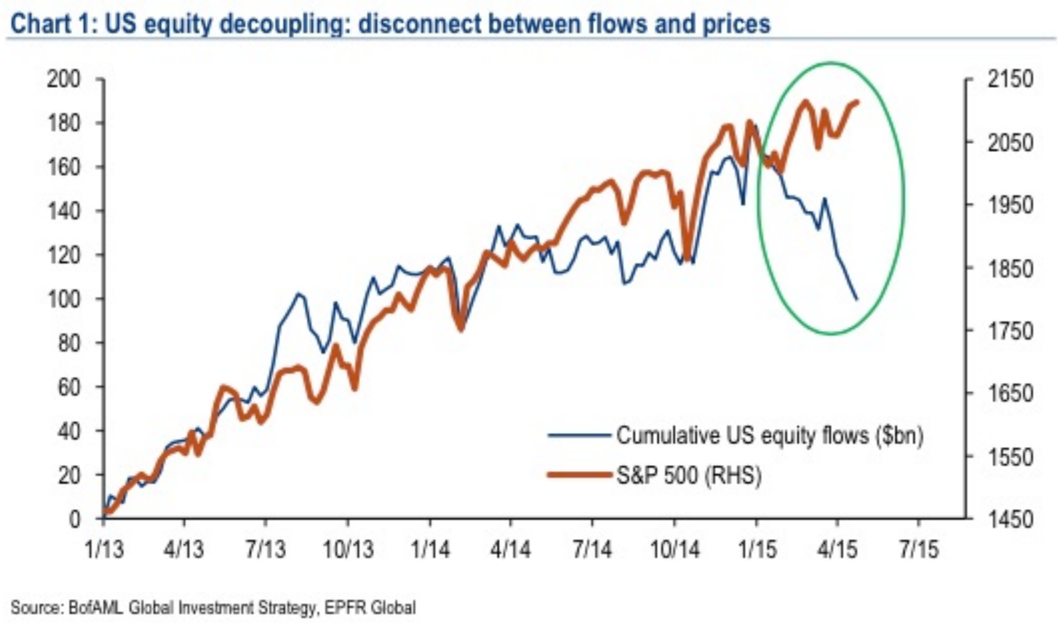

Figure 1: Equity flows were negative while S&P500 rallied

Some have ascribed the rally to the attractive spread of dividends over bond yields, but hardly anybody makes this kind of allocation decision. The real story is one of corporate buy-backs overpowering bearish professional and retail investors.

Individuals and professional investors have both been consistent net sellers of equities, which would surprise no-one, given the bearishness of commentary since 2009. This selling was outmatched by corporate buyback programs. Recent rallies have been driven by corporate firms buying back their own and other companies stock.

This is important as it determines the importance of investor sentiment vs corporate capital allocation decision making to market prices. At the moment the market is led by corporate treasurers borrowing cheaply to buy their own stock.

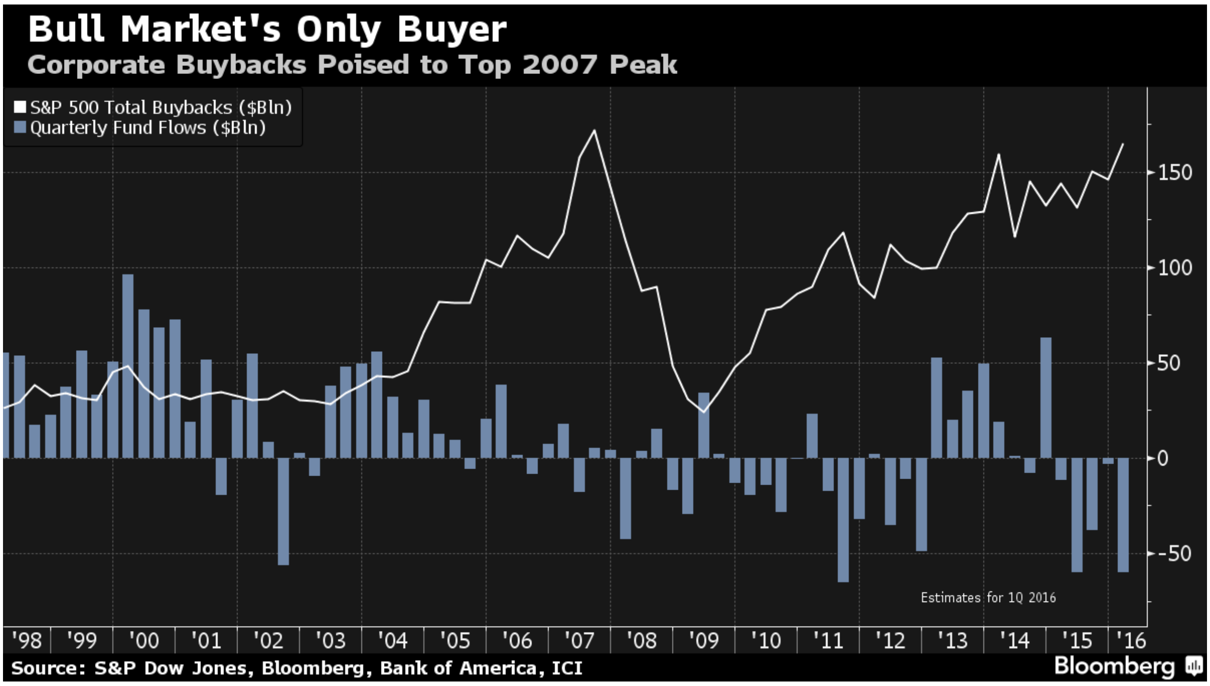

Figure 2: Quarterly Fund flows have mostly been negative since 2009 but the market has rallied strongly.

This is crucial to the fund's strategy, as we have wide discretion over how much to hedge. Putting aside whether large corporate buyback programs are 'good' or 'bad' (we'd say it depends on absolute valuation) we expect this dynamic to continue while funding costs are so low. Using cheap debt to buy back stock should technically be a neutral value proposition, but in practice this kind of activity drives up share prices, the true concern of executives and shareholders.

Other positives for the corporate sector include the low prices of wages, interest rates and, since 2011, energy and minerals.

From here there seem to be two possibilities. Bonds may continue their rush to zero (and below), while credit and equity markets continue to rally. We are prepared for this scenario by being fully invested in our best ideas, while purchasing very cheap upside protection on our hedges. The corporate buyback dynamic would continue to drive markets, while M&A and capitulation by under-weight investors could provide a further substantial boost to valuations.

The second highly feasible scenario for the United States is that low interest rates and low wages reverse. Unemployment is so low in the US and is now below 5%, so substantial wage increases are feasible. This would lead to a higher US dollar, cheaper commodities, and depressed equity valuations. While valuations would likely compress, this would only occur in a bullish scenario when growth and other key metrics were positive, so this would also be positive for equities. The fundamental denominator should grow, even if the price numerator compresses. This would be quite bullish for non-US commodity producers.

Labor Force Statistics from the Current Population Survey

Series Id:	LNS14000000
Seasonally Adjusted	
Series title:	(Seas) Unemployment Rate
Labor force status:	Unemployment rate
Type of data:	Percent or rate
Age:	16 years and over

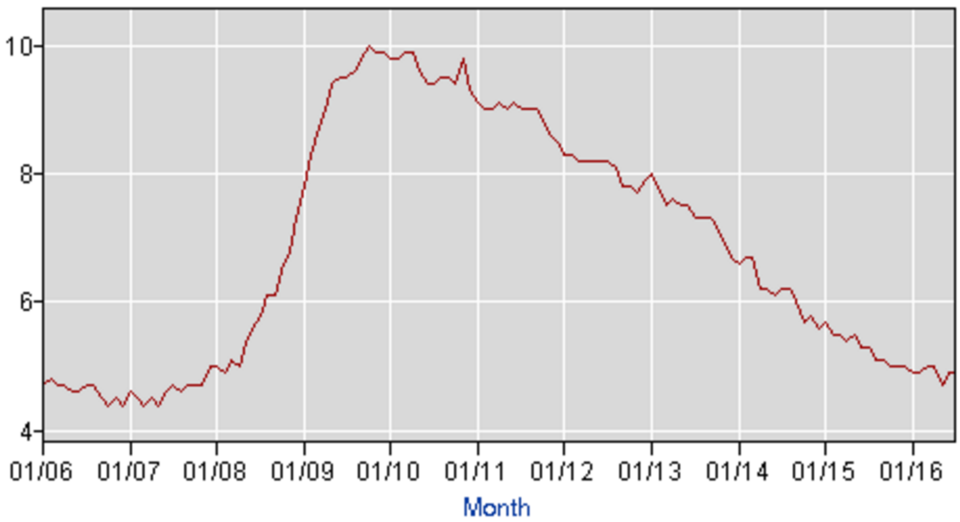

Figure 3: Employment rate has fallen steadily since 2010 and is now at levels consistent with normal wage growth and inflation.

In the UK Brexit will give Mark Carney and his successors years of excuses to keep rates low. This will depress the pound, but we think it almost certain that this will lead to appreciating GBP house prices and booming industry. There are enormous speculative bets being placed against the pound, we remain ~15% long. Why?

Firstly we are happy to bet that the UK will remain the most attractive city in Europe for migrants and businesses. You cannot simply recreate the enormous market for talent and living conditions of London elsewhere.

Secondly Government policy has become vastly more accommodating. David Cameron made a calculated bet on austerity to secure his second term. He sold this program of cuts when both common sense and economic consensus was in favour of further stimulus. Casting artists, builders and Government employees into one of the weakest employment markets of our time was only going to depress wages, spending and community wealth.

The argument for frugality, that it would push up rates and borrowing costs and eventually cause a crisis, has the logic totally reversed. Borrowing costs are lower than ever and we may never know how much David really believed in such foolish policies. Either way after so many years the evidence is in: he won the election and you can reverse rank the strength of national recoveries by the severity of their austerity policies.

Theresa May has no such politics and no need to demonstrate fiscal responsibility. She has already launched stimulus and an industrial policy, which means serious Government support for industry. This is bullish for the economy, bullish for markets and bullish for the pound. It's also good news for the Brits.

Thirdly press reports of recreating a financial center elsewhere in Europe are wide of the mark. The EU Commission is bringing in a punitive financial transactions tax in Europe, and there are regular attempts, often successful, to restrict corporate and financial sector pay. The current French Prime Minister was elected on a promise to introduce a 75% tax rate. The most important and lucrative parts of finance: the deployment of risk capital, will remain in London.

For all these reasons we re-entered our GBP position at around 1.34 despite realising losses worth around 2% of the portfolio on the day of Brexit.

Market conditions in July were actually very poor for our strategy. Hedges detract from performance when markets rally in straight lines, especially as we are typically long volatility. That's the point. Gladly our stock-picking made up for the hedges and we outperformed the market anyway.

Comments on Hedging Strategy

We currently hold an unusually large short position (38%) in the S&P 500.

I rarely short the equity market as it is positively yielding and compounds over the long term. The VIX, on the other hand, is mean reverting and can double or more in days. These are more suitable dynamics for a hedge. In June the usual state of affairs was reversed: the VIX was relatively high (around 20) while US equities – unlike most markets around the world - were close to all-time highs.

For these reasons we weighted the hedge book to a short S&P500 position rather than 'long' VIX.

Due to the structural skew of the market there was a favourable opportunity to buy cheap calls to hedge this position itself, so further losses in the short equity position are limited. This part of the trade is performing as expected.

Macro Trading

The fund entered and closed profitable trades in gold miners, USDJPY and AUDEUR. We also made profitable trades in South Korean equities (since closed), Brazilian equities and German equities. These trades were expressed as ETFs. We continue to hold a mid and long term treasury positions. The trades add duration to the portfolio and we expect this to be helpful the next time there is a sell-off. They are also positive yielding with a positive expected return (compared to our short equity position which is negative yielding with a negative expected return).

The AUDUSD is still looking favourable and entirely anomalous at 1.75% benchmark rate as of July 31, 2016 (since lowered to 1.50%).

UK and Europe

After the Brexit vote we exited our FTSE index positions and re-orientated towards the most promising sectors, many of which were down over 50% that day. Our largest positions were in listed real estate developers. The backdrop remains supportive of prices, with housing starts well below household formation rates. There remains popular support for policies that drastically reduce supply, like the green belt around London.

These business have multiple strategic levers they can pull to mitigate any temporary slow-down (price vs pace of volume delivery) and I'm confident that any slow-down in UK home purchasing activity will be deferred rather than destroyed, and these stocks will recover. This has been a successful play so far.

We also purchased small stakes in Barclays and Santander. These provide a high beta to any European recovery, and are cheap by most metrics. Santander is the highest quality Spanish bank, while Barclays has a leading position in UK retail. We are currently assessing switching the exposure to Lloyds or adding Lloyds as a separate position, given that it has the domestic retail exposure of Barclays without the pretensions to investment banking.

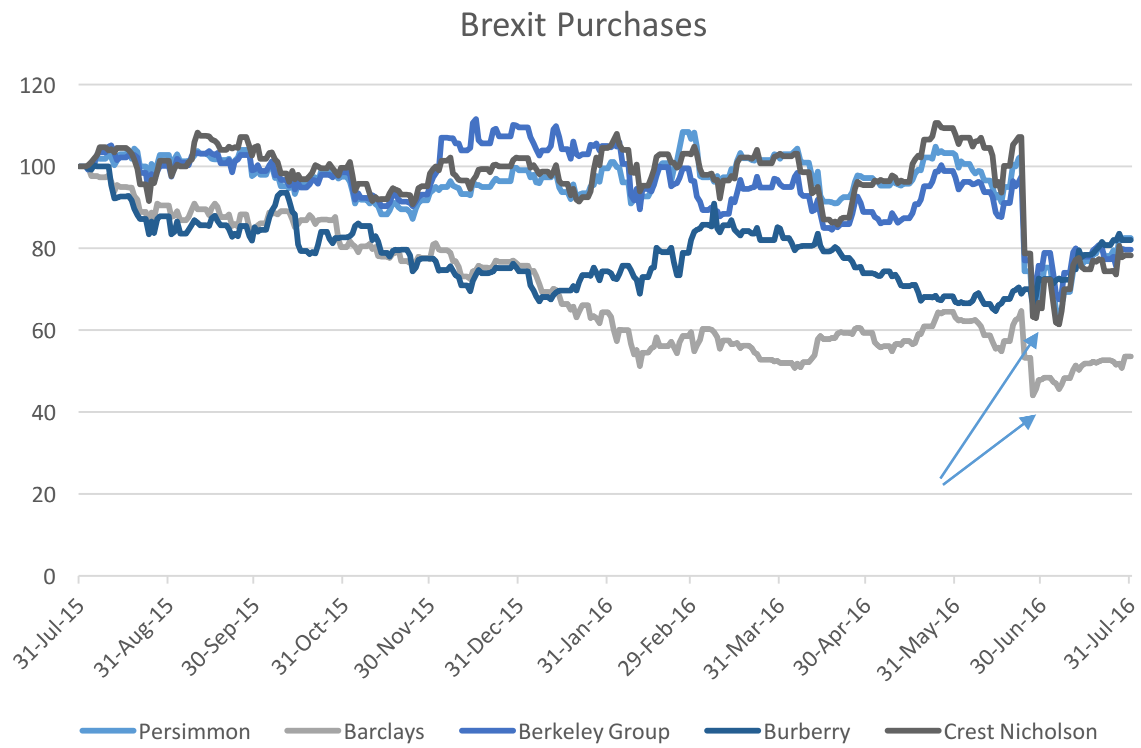

Figure 4: Stocks purchased in the days following Brexit.

Pharma and Biotech

The Biotech sector is at an interesting junction. There was a huge bull market over the past few years as a number of long-promised treatments in oncology and virology were finally approved. Examples include immuno-oncology, the effective cure for Hepatitis-C owned by Gilead and single pill regimens for HIV.

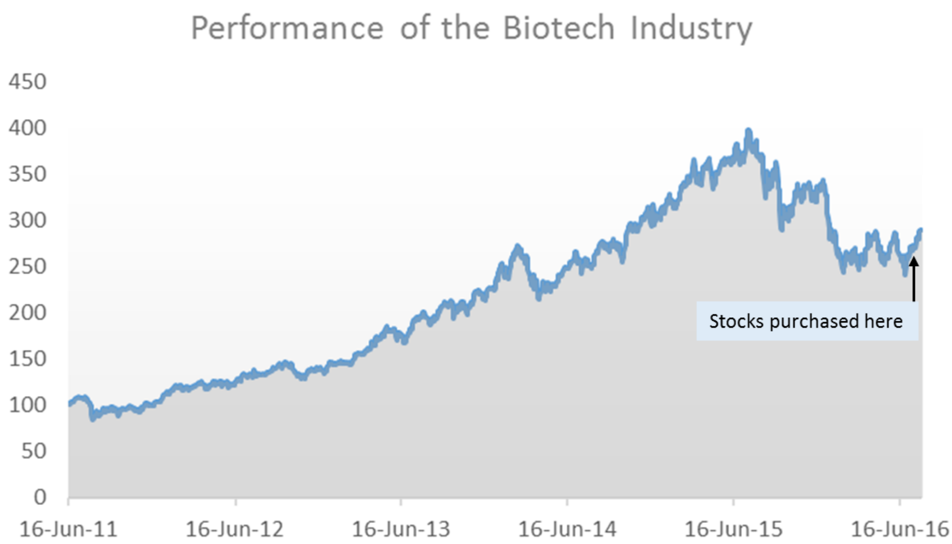

Figure 5: This shows the performance of IBB, a broad biotech ETF.

The cost of some of these treatments runs into six figures. While it seems somewhat mercenary to discuss lives in dollars and cents, these astronomical prices subsidise the rest of the world. Curing a disease that would otherwise require a liver transplant, or result in a year of intensive care or death is extraordinarily valuable to society and the individual involved. These drugs are worth their prices and are good 'value' for the insurance companies that end up paying them.

The recent problems in the industry began when companies like Valeant pushed pricing too far. Valeant triggered an M&A boom, where companies would merge for tax reasons, strip out all research costs, and jack up prices by many multiples to justify non-commercial deals. The equity valuations of companies in the sector rose.

With the collapse of Valeant the game is up: there is political talk of regulating price increases (which at the very least will now be closely scrutinised), ending tax inversions and acquisition-as-a-business-strategy has been discredited in biotech, as it has every other time and place it pops up.

This left a number of companies looking rather cheap and has provided the Fund with an excellent entry point to an industry with robust, defensive, non-cyclical cash-flows that will benefit from aging populations around the globe. We have been careful to avoid companies whose cash-flows depend on recent price increases.

The first position we took was Gilead Sciences - who provide a cure for Hepatitis C and a once-daily pill regimen for HIV management.

Gilead spends extraordinary sums on research and development. Their enormous pipeline is encouraging, though it will be difficult to replace the economic dynamics of their existing portfolio. Despite fears of a slow-down, revenue only contracted 1% year-on-year in their most recent financial results.

Other positions include Amgen, Abbvie, Celgene and Horizon Pharma - all with extensive pipelines. We entered, then exited Endo Pharmaceuticals after judging that Celgene, Abbvie and Amgen had better prospects and lower business risk. The performance of our selected equities will be monitored carefully against the performance of IBB, an ETF that encompasses a larger number of companies. It may well be that IBB is a superior risk-adjusted way to express this thesis, but after a short period we are outperforming.

Whether to invest via indices or companies directly is an excellent question and the answer is industry and category specific. In areas like oncology, it's likely that multiple late phase candidates will be used together and a number of companies will benefit. In others instances, such as the race to replace Gilead's Hepatitus-C treatment, there are likely to be more losers than winners.

In the first instance it's best to have exposure to the entire industry and benefit from index weighting advantages (indexes will always hold the most successful companies). For these reasons we are planning to slowly build a position in IBB over the coming months. As for the second, a mix of stock selection and luck is required. There is no way to predict the outcome of clinical trials, though a number of financiers are in jail for trying too hard to do so.

Tech

We have positions 4-5% positions in Apple, Baidu and Alibaba.

Apple is trading at an extraordinarily low valuation that effectively values its brand at nothing. Year-on-year numbers are weak but we believe this is largely due to Apple's 18 month upgrade cycle. We expect the lock-in effects and superior brand quality of Apple to ensure that the iPhone 7 is purchased as enthusiastically as ever, and this will lead to stock price appreciation.

The main risk is that durable existing smartphones are 'good enough' and Apple's margins collapse, however we think the iPhone premium is well justified. There are years of evidence that consumers are able and willing to pay the Apple premium, and perhaps they will be more so now that smartphones are so deeply imbedded in all of our lives.

Apple's margin strength comes down to brand power, which derives from both design but also intrinsic qualities, such as being able to control all aspects of the user experience in a way impossible for Samsung on Google's operating system. Simple actions like scrolling and clicking are still noticeably superior on Apple devices.

Baidu has a dominant market share in China and we expect the firm to follow Google's playbook. Its market cap is about one tenth of Google's, while they have additional profit levers (such as paid in-column search) and a clear strategy. They can follow Google's strategic footsteps in a market that Google is largely excluded from.

Alibaba is comfortably ensconced as the leading ecommerce player in China's market and we expect it to continue to grow as China develops into a consumer market. The runway here should be decades long. We passed on Tencent for now due to valuation concerns and limited upside, but this may change.

High Quality Mining, Refining and Energy

The mining boom shows spectacularly inelastic supply on both the up and downside. We don't want to pick a bottom while supply in so many commodities continues to increase, however we were comfortable initiating positions in the highest quality names: Valero (the largest US refiner), Glencore and BHP.

We have also moved against consensus with coal, expecting the dramatic supply response to lead to higher prices and stability. So far this has worked out - Whitehaven Coal is one of our best performers, and Alliance Resource Partners has also generated profits.

The steep falls in thermal and metallurgical coal prices prompted a rapid reduction in mine output and recovery in pricing. Many mines are being closed around the world for environmental reasons, including places like China. Whitehaven has outperformed due to its shielding by the weakening Australian dollar, while US domestic miners have suffered, with the most prominent entering bankruptcy (Peabody, Walter, Arch, etc). US miners are more exposed to currency volatility, as the commodity prices themselves have a greater and shielding influence on the Australian dollar compared to the USD, which is largely driven by other factors.

Blue chip Australian dividend payers

Australian banks sold off on concerns over capital raisings and the defensiveness of their dividends. These are some of the highest dividend payers in the mega-cap space, and we expect the Australian oligopoly to provide outsized profits into the future.

We are confident the overall leverage ratios on the banks mortgage books are low enough to provide security, while actual losses in the mortgage books of these banks have remained minimal. Falls of over 50% would be required for serious capital destruction.

We have some concern over business banking but it's important to remember that the doomsday commodity scenario in Australia has just occurred and banks have survived comfortably.

Summary

The past few weeks have been a period of high activity. With the benefit of hindsight it would have been better to have held neutral GBP exposure going into the Brexit election. This has been carefully noted and reflected upon. Returns have been significantly depressed by hedging in the rallying equity market, but frankly we have still outperformed the market and expect the hedge portfolio to eventually have its own day in the sun.

The relative performance of the portfolio vs the S&P500 is monitored on an intraday basis, and we will never let the hedges dominate the portfolio performance in benign, appreciating markets like the current ones.

Market prices right now are strange. I can understand the logic for zero yielding government debt in a deflationary environment, but why hold negative yielding debt over cash? There have been days in over this period when treasuries, gold, and equities have all risen. This is novel behaviour and demands attention. Time will tell whether the US will continue to be the leading performer amongst global equity markets.

We must also remember absolute US valuations are high – justified or not – and we are seven years into a bull market which surprised almost everyone. Now for the first time there appears to be a serious consensus that stocks will continue to rise, and this may also lead to trouble for markets in the coming months and years.

For the next month we anticipate only minor changes to our portfolio. We will remain both fully invested in our best ideas and very conservatively hedged. If we play our cards right we will have our cake, and eat it too.

Michael Frazis