Aurora Updates
Market Opportunities and Portfolio Themes

25 February 2014

Executive Summary

- Current market conditions and opportunities inform two main investment themes for the Aurora Fortitude Absolute Return Fund:
    - Current low cost of protection and market valuations being no longer cheap indicate the attractiveness of the Fund's key protection strategy. Part of Aurora's unique skill set is managing the protection strategies to deliver better risk adjusted returns to investors.
    - Primary issuance of hybrids is creating opportunities in short end secondary transactions without the duration risk due to their predominantly floating rate coupon structure as well as the shorter maturity.
- The transactions in the merger and acquisition space continue to be monitored for any pickup in activity.
- These themes highlight the key feature of the multi-strategy management of the Aurora Fortitude Absolute Return Fund. The portfolio managers use a broad range of strategies within the portfolio for investment and to manage risk.

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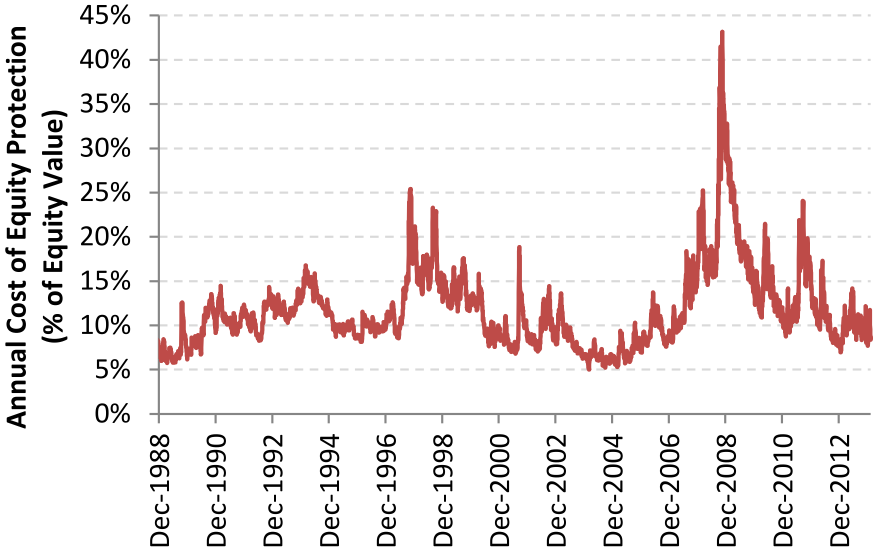
Low Cost of Protection

A key investment strategy for the Aurora Fortitude Absolute Return Fund is the use of protection strategies to reduce overall investment risk as well as allow risk taking in other parts of the portfolio – see our note "Why Do We Pay for Protection?", *Aurora Updates*, 10 December 2014.

Figure 1: Annualised Cost of Protecting Australian Equity Investments



Source: Aurora Funds Management

Despite the large absolute cost of protection, we at Aurora perceive current pricing is attractive in two ways. Firstly it is relatively low compared to historic prices (Figure 1). Secondly, the best time for buying protection is when the market is overly complacent about downside risk and consequently demand for protection is low. The same is true for any form of protection, whether it be house insurance or protection of equity assets. The converse of this perspective is that when prices are high for protection (such as in 2008 and 2009), Aurora's protection strategy adjusts to accommodate the changing market price of protection.

Figure 1 above shows emphatically that the market is in a low perceived risk environment - in our opinion, it is worthwhile holding protection. The challenge for any investor is to integrate and rationalise such protection strategies within the overall portfolio context.

At Aurora we integrate protection within the total portfolio in four ways:

1. Focus on delivering better risk adjusted returns, and

2. Offset other strategies in the portfolio to deliver balanced total fund risk and return characteristics, and

3. Employ expertise and dynamic strategies to reduce the cost of protection, and

4. Simple measures of risk, such as volatility, hide the real impact of 'market gravity' which increases market risk on the downside. Essentially markets

accelerate on the downside – as markets fall, risk levels rise and so further large falls are more likely.

A key reason to focus on protection strategies at this time is the changing Australian market valuation and constitution:

- With the rally in Australian equity prices over the last two years, prices are currently fairly priced rather than cheap. Morgan Stanley data shows the market is trading expensive based on past earnings (Figure 2) however this reverts to fair value given the expected 9.3% rise in earnings based consensus forecast earnings per share (Figure 3). Market risks on the downside will be fundamentally greater when the market is fairly valued rather than the buffering provided when the market is cheap.

Figure 2: Australian Equity Market Price / Earnings Ratios

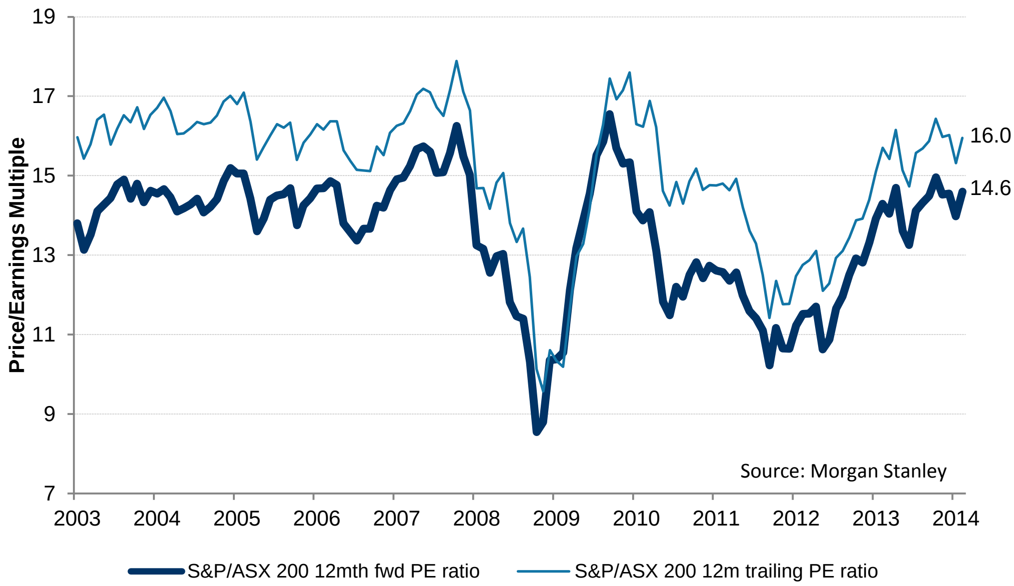
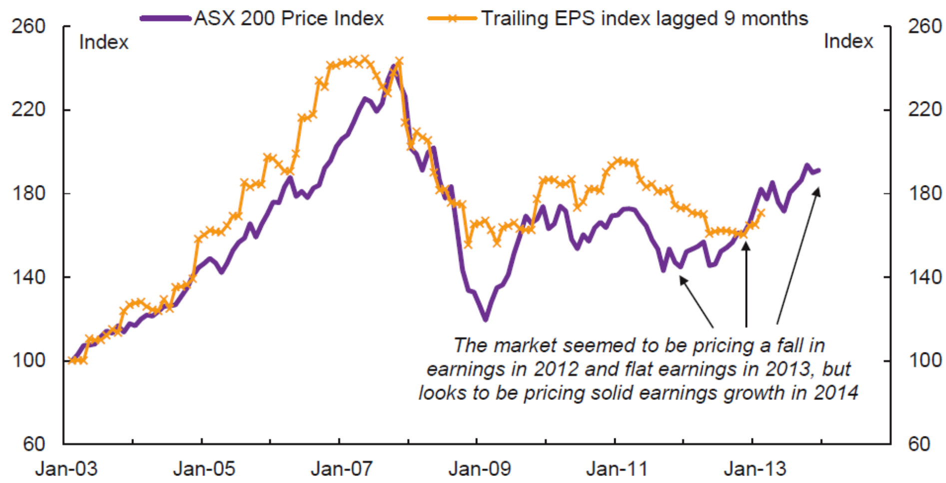


Figure 3: Australian Equity Market Price and Earnings Index



Source: Datastream, Citi Research

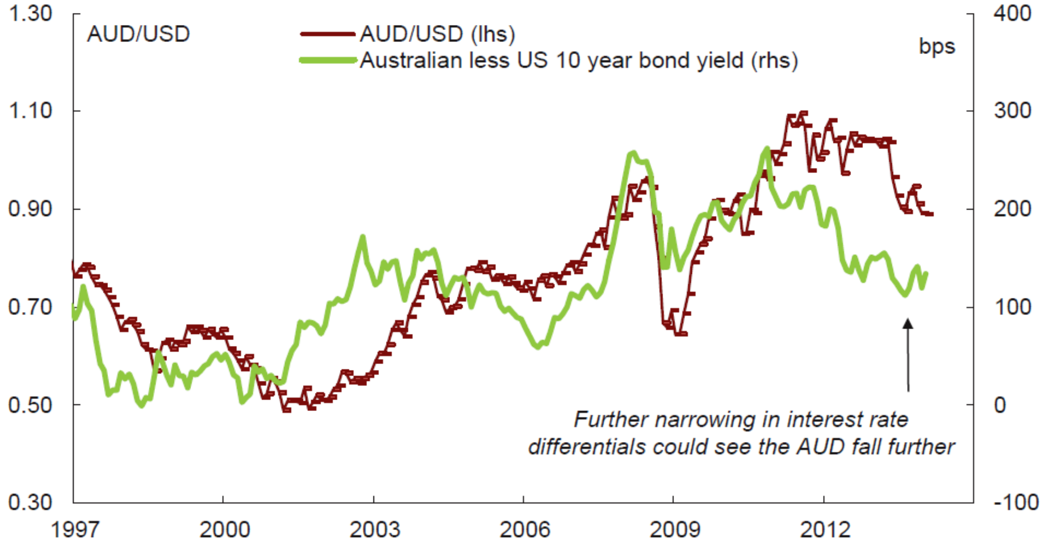
- The Australian equity market continues to evolve into a more concentrated financials and resources equity market. A recent example is the local delisting of 21st Century Fox.
- External factors maintaining an elevated local market risk include:
    a. Heightened uncertainty over other countries' economies and markets:
        - Questions over US recovery and US jobs outlook.
        - Japan's ongoing recovery and fiscal stability.
        - China growth and global resources outlook.
        - Europe post the debt/sovereign crisis over the last five years and reregulation of the financial sector.

    b. New US Federal Reserve Chair and uncertainty over policy. Policy uncertainty includes tapering (quantitative easing stimulus withdrawal in the US) and potential future interest rate tightening (an increase in Fed funds is not expected until mid-2015). Rising US bond yields will potentially flow through to domestic yields and so negatively impact market valuations – particularly banks and financials.

    c. Continued uncertainty over the A$ exchange rate and overvaluation could keep offshore investors wary of the market (Figure 4).

    d. Continued rotation out of equities and into fixed interest with possible rising bond yields.
- There may be additional market uncertainty triggered by uncertainty of local monetary and budget policy with a new federal government.

Figure 4: AUD/USD Exchange Rate and Bond Yield Differential



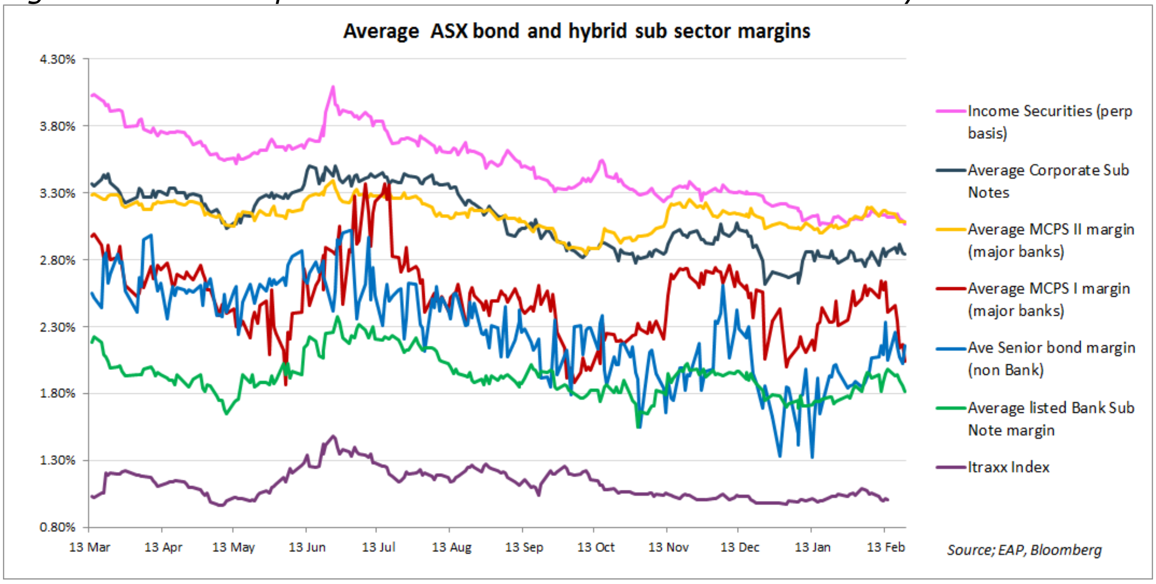
Source: RBA, Datastream, Citi Research

With these potential risk drivers for the Australian equity market, the current low price of protection strategies will be a major focus for portfolio management in the first half of 2014.

Short Term Hybrid Opportunities

In line with other risk metrics, a consistent phenomenon in the fixed interest markets has been the decline in credit spreads both for listed and unlisted securities (Figure 5, compare with Figure 1 above).

Figure 5: Credit Spreads on Australian Listed and Unlisted Hybrid Issues



Recent issuance in this market has been strong with this month ANZ rolling over their $1.1 bn preference share issue due in June 2014 with a $1.3 bn capital notes issue. In December 2013, NAB saw combined demand for $2.5 bn and issued only $1.5 bn.

This demand and issuance has been driven by two main factors. Firstly, buoyant equity market environments have seen many issuers rolling over early. Secondly, the tier 1 capital treatment by Australian Prudential Regulation Authority for these securities is well established and many issuers replace like for like when planning their capital structure.

Forward issuance is similarly strong with WBC having a $0.9 bn issue maturing in September 2014 and CBA having a $2.0 bn issue maturing in October 2014. As noted above, it would be reasonable to expect these issues to be rolled early. Market speculation is a number of smaller issuers may come to the market from the likes of IAG and Heritage Bank.

There is significant demand for non-financials if they were to come to the market due to the concentration of financial issuance. However, it is not expected that this high concentration in financials will change in the short term. Many of the issuers of perpetual and reset securities are expected to consider rolling into compliant structures as perpetual and reset securities lose their tier 1 status under Basel III. Again, buoyant equity markets may be the trigger for issuers to roll early rather than towards the end of the Basel III implementation period in 2022.

Opportunities in this market for the Aurora Fortitude Absolute Return Fund come from a variety of sources. Firstly, listed issues trade consistently 40 to 50 basis points wider (cheaper in price) compared to unlisted issues. Secondly, long end issuance creates short end opportunities as investors sell exiting assets to fund the purchase of new assets.

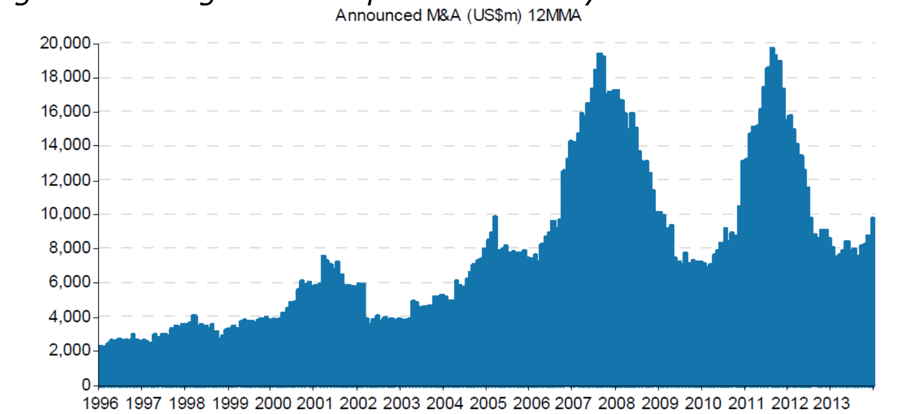
Rising bond rates could be harmful for a fixed interest book. Aurora Fortitude Absolute Return Fund's portfolio of hybrids has negligible duration risk due to the short maturity of the book and the fact most of the holdings have floating coupon structures.

The heavy concentration in financials in the yield portfolio informs the configuration of our protection portfolio. We are correspondingly heavily focused on bank and other financial protection transactions.

Merger and Acquisition Deal Flow

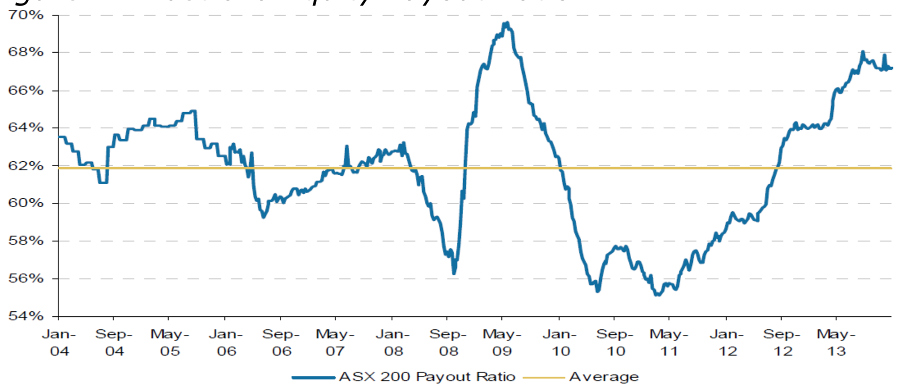
In the Australian market, merger and acquisition activity has been subdued in 2013 (Figure 6). Listed companies are rewarded more for returning cash to shareholders rather than more growth strategies, however this trend may have run its course with dividend payout ratios at decade highs (Figure 7). Global activity is similarly subdued. Potential triggers for a step up in Australian activity may be the low A$ and accommodative monetary policy.

Figure 6: Merger and Acquisition Activity in Australia



Source: Company Data, Morgan Stanley Research

Figure 7: Australia Equity Payout Ratio



Source: Datastream, Morgan Stanley Research

Note

The Aurora Fortitude Absolute Return Fund (ARSN 145 894 800, APIR Code AFM0005AU) has been issued by Aurora Funds Management Limited.

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