Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – October 2016

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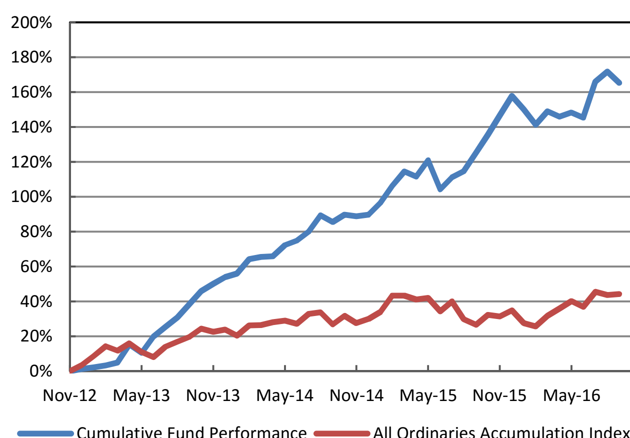
Welcome

Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (Fund) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we discuss how our approach to risk frames our investment process.

Fund Performance

The Fund returned negative 2.37% net of fees during September 2016. This compares with the All Ordinaries Accumulation Index return of 0.43%. Average gross capital employed by the Fund was 121.4% long and 8.9% short. Average net exposure over the month was 112.5%. At the end of the month the Fund had 30 long positions and 6 short positions. The Fund's biggest stock exposures at month end were spread across the financials, real estate, consumer discretionary, consumer staples and telecommunications sectors.



Fund Returns

Period	Auscap	All Ords
September 2016	[2.37%]	0.43%
Financial Year to date	8.15%	5.33%
Calendar Year to date	2.90%	6.97%
Since inception	165.30%	44.23%

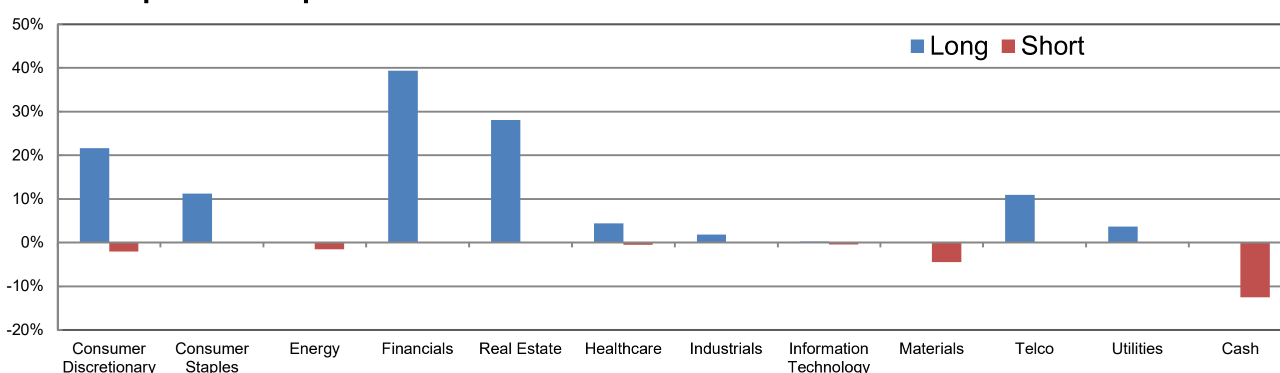
Fund Exposure

September 2016 Average	% NAV	Positions
Gross Long	121.4%	31
Gross Short	8.9%	6
Gross Total	130.3%	37
Net / Beta Adjusted Net	112.5%	77.9%

Fund Monthly Returns

Year	Jul %	Aug %	Sep %	Oct %	Nov %	Dec %	Jan %	Feb %	Mar %	Apr %	May %	Jun %	YTD
FY13						1.35	0.74	1.23	1.46	9.83	(4.05)	8.32	19.72
FY14	4.70	4.28	5.84	5.46	2.86	2.57	1.32	5.32	0.70	0.29	3.82	1.48	46.01
FY15	2.95	5.24	(2.09)	2.25	(0.43)	0.44	3.65	4.90	3.98	(1.36)	4.43	(7.55)	16.81
FY16	3.46	1.64	4.82	4.65	4.69	4.56	(3.01)	(3.54)	3.22	(1.24)	0.96	(1.19)	20.13
FY17	8.48	2.13	(2.37)										8.15

Sector Exposure - September 2016



Part 1: Risk management and how it frames our investment process

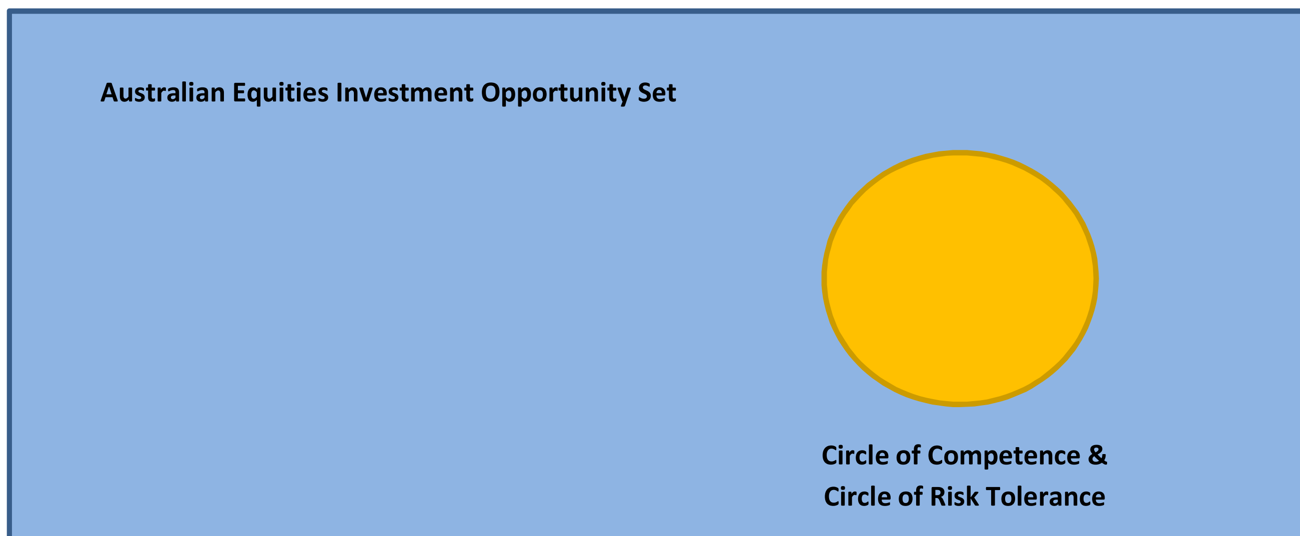
Most seasoned investors agree that an understanding of risk is a critical part of the investment process. Some investors adopt an investment approach and then try to manage the risks associated with the investments they have made. For Auscap, risk *frames* our investment approach. Management of risk comes first, prospective return second. There are risks we are prepared to accept to deliver returns for our investors, and there are many risks we are not prepared to accept. Specific risk intolerance is our first investment filter. It reduces the number of companies we would assess as prospective Fund investments by, conservatively, at least half of all the Australian listed companies we meet within five minutes of analysis. Over the next few newsletters we intend to share a few of our views on risk and the way it shapes how we invest our unitholders' capital.

Risk comes in different forms. The most obvious, but not always most important, risks associated with investing in equities are the business risks that exist for the particular company under consideration. Peruse through any company prospectus and there is always a reasonably lengthy section titled "Key Risks". It is not a section that typically demands much attention from many investors, despite often containing alarming statements. These business risks will generally include:

- **Revenue risk** – the company may lose key customers or contracts and is unable to replace them.
- **Competition risk** – new competitors might affect sales and/or profit margins, lower prices or increase supply to gain volume and market share.
- **Consumer or product risk** – consumer preferences may change, affecting product or service demand.
- **Input cost and supply risk** – the prices of the component parts that are used to produce the products or services may become more expensive and this may be unable to be passed through to the customer. This includes risk associated with foreign exchange and commodity prices. Alternatively the input products may become unavailable due to supply chain or resource issues.
- **Key person risk** – the business is dependent on a particular individual or small group of individuals and those individuals decide to leave.
- **Management risk** – management might not act in the best interests of shareholders (**agency risk**) or make mistakes in the management of the company that materially affect the value of the enterprise.
- **Financing and interest rate risk** – a change in interest rates or financial conditions could affect the company's operations should they have substantial borrowings or have a business tied to the growth, availability or cost of credit.
- **Technology risk** – changes in technology may disrupt historical business activities or consumer behaviour, making the company's products or services redundant.
- **Regulatory risk** – a change in regulation might affect how and whether a company can continue to carry on its business activities.
- **Defective product risk** – the company may deliver products that fail to achieve their purpose, or have a safety defect that renders the product redundant or recalled.
- **Economic risk** – broad economic conditions may deteriorate, affecting company sales and profitability.
- **Research and development risk** – outcomes from research and development may leave the company with inferior products or services, consume too much of the company's resources in order to maintain pace with competitors, or fail to achieve delivery of a product or service capable of being sold to consumers.

This is far from an exhaustive list of company specific risks. To be able to analyse all of the risks of a particular business in a logical, rational and calculated way is a very difficult task. It leads us to a reluctance to invest in businesses that we are not inherently familiar with. We prefer businesses where we are personally customers of the company, or have friends and family who are customers, or where we know businesses who are customers. It is more likely that we are going to be able to identify and monitor company specific risks if we are familiar with the business and are regularly in contact with its customers.

We aim to invest within our circle of competence. Understanding our circle of competence allows us to filter a lot of investment opportunities quickly. Our circle of competence contains companies and industries where we believe we have sufficient knowledge to reasonably evaluate business risk. It does not typically contain the new and exciting businesses that have sprouted up over the preceding years. We like to use the following diagram to explain that our circle of competence, even after over 30 years of combined investment experience, is not particularly large. If the rectangle represents the investable universe for the Fund (listed Australian equities, of which there are over 2,100), our estimated circle of competence by number of stocks might be as per the circle within the diagram. It is worth noting that this circle would be substantially larger if it was by market capitalisation, because many of the stocks familiar to us are large and mid-capitalisation businesses.



It might surprise our investors to discover that our circle of competence appears quite small! We accept that it is and try not to stray from the circle. We expect that over time the circle will grow, albeit slowly, and our understanding of the companies within the circle will continue to improve. The circle currently represents perhaps a few hundred listed companies from which we are hoping to make perhaps thirty to forty investments.

The circle of competence is also a circle of risk tolerance. We try to understand where risk is likely to be most invisible and avoid it. There are plenty of businesses that carry on complex operations. Some of the operations are complex out of necessity, for example where the company is carrying on business in a field requiring a lot of specialist expertise. If the company's endeavours are not familiar to us, or if we do not have the required specialist knowledge, we don't buy a "Book for Dummies" to try to get up to speed. We just avoid investing. We have no interest in putting ourselves in a situation where it takes us a reasonable amount of time to evaluate a company announcement *ex post* due to a lack of knowledge.

Sometimes operations are *unnecessarily* complex. These opaque business models are normally complex for a reason. We often say to our investors, if we cannot describe how the company makes money on the back of a business card, we are not interested in investing. If a lot of the company specific risk is not familiar to us, then we will avoid the investment opportunity. Minimising risks that we are unfamiliar with is the converse of stating that we try to invest within our circle of competence.

We do not spend too long trying to understand many companies outside the circle, because we don't believe that this is the most productive use of our time. Doing so would still only provide us with a superficial understanding of the risks and issues facing these companies, and time spent trying to unsatisfactorily get up the curve risks detracting from time spent assessing opportunities within our perceived circle of competence.

If we were an index-aware fund, making this decision would not be possible, because many significant index performers might fall outside our natural circle of competence, and ignoring these could impact relative performance. We would rather be a risk-aware fund than an index-aware fund, which will inevitably lead to periods of underperformance against certain indices, but we hope will provide our investors with better risk-adjusted returns over the long run.

The most obvious situation we avoid as being beyond our circle of competence and above our risk tolerance threshold is trying to evaluate a company's prospects of becoming financially viable when they are not currently profitable. This leads to a set of valuation parameters that must be in place for us to consider investment. We have no particular interest in trying to work out whether a specific company will generate substantial cash flows at some point in the future, whether they will deliver a strong return on invested capital, or whether they will be profitable. We prefer to invest in companies where that has already been demonstrated, typically over a substantial period of time.

At Auscap we focus on investing in companies that generate substantial and growing cash flows and deliver an acceptable return on invested capital. We place companies where there is no historical proof of this outside our circle of competence. There are many indicators of whether a company will generate substantial profits for its shareholders, we prefer the most reliable one: evidence. As investors we are happy to accept risk, as long as we believe that we have some understanding of, and ability to assess, the risks involved. As we will continue to explain in next month's newsletter, the risks we are willing to accept as investment managers in many ways define our investment approach.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website http://www.auscapam.com and follow the registration link on the home page. Interested wholesale investors can download a copy of the Auscap Long Short Australian Equities Fund Information Memorandum at www.auscapam.com/information-memorandum. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

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