Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – February 2013

Welcome

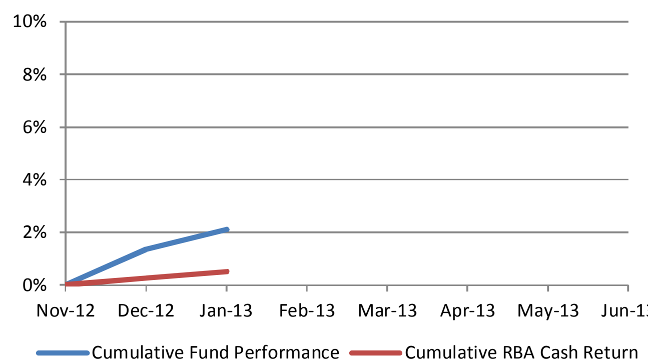
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In the last few months the Australian stock market has performed strongly. Is it time to buy? Is it time to sell? In our second edition we look at what might be driving Australian equities higher and whether the yield differential between equity and bond markets is likely to continue to see investors participate in "the great rotation" from bonds into equities.

Overview

The Fund was launched in December 2012 and targets strong absolute returns in excess of the RBA Cash Rate. The Fund focuses predominantly on fundamental long and short investments while utilising a multi-strategy approach to take advantage of shorter term market opportunities to increase returns, hedge the portfolio, protect capital and minimise volatility where prudent. The Fund will typically have 25-45 positions primarily in liquid stocks in the ASX200. Further information, including access to the Fund's Information Memorandum for sophisticated investors, is available at our website www.auscapam.com. Correspondence can be directed to info@auscapam.com.

Fund Performance

The Fund returned 0.74% net of fees during January 2013. This compares with the benchmark return of 0.25%. Average gross capital employed by the Fund was 107.7% long and 83.7% short. Average net exposure over the month was +24.0%. At the end of the month the Fund was long 25 stocks and short 13. The Fund's biggest exposures at month end were in the financials, materials and consumer discretionary sectors.



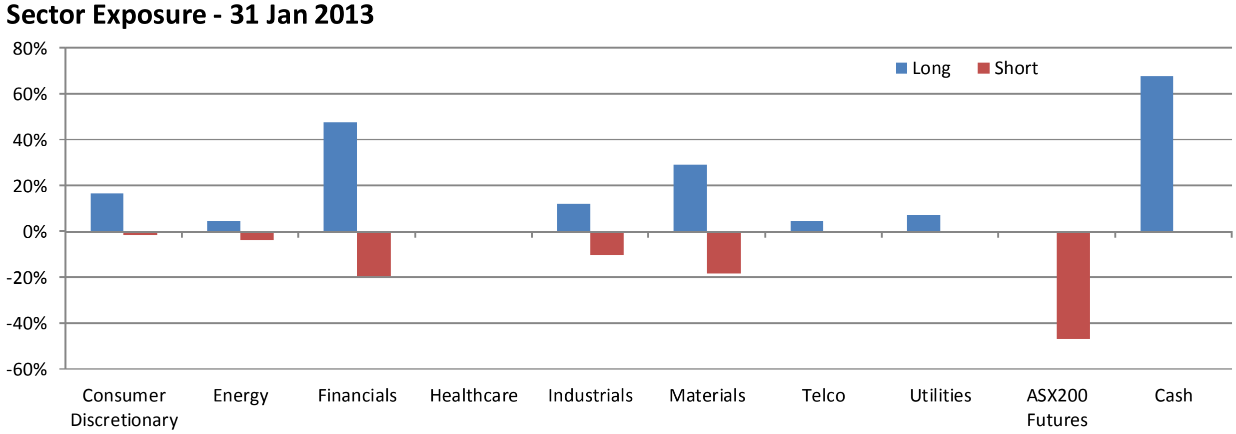
Fund Returns

Period	Auscap	Benchmark
January 2013	0.74%	0.25%
Financial Year to date	2.10%	0.51%
Since inception	2.10%	0.51%

Fund Exposure

January 2013 Average	% NAV	Positions
Gross Long	107.7%	23
Gross Short	83.7%	11
Gross Total	191.4%	34
Net	24.0%	

Sector Exposure - 31 Jan 2013



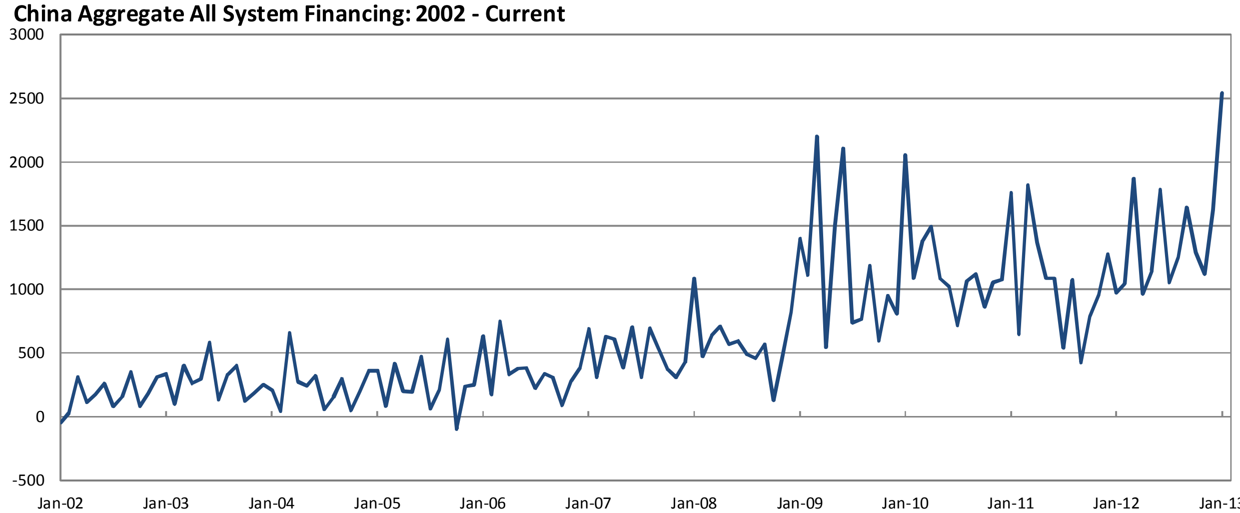
Are we back in a bull market?

The strength or weakness of a stock market is typically seen as a forward looking barometer for the strength of the economy. In the first edition we discussed the importance of growth in the Chinese economy for the Australian economy. If Australia's economic growth is dependent on China's, then it follows that their stock market may be a lead indicator for the Australian market. Since the start of December China's Shanghai A-Share Index has risen nearly 25%. If this is an indication that growth in China is improving then there are obvious positive ramifications for the Australian economy and its stock market.

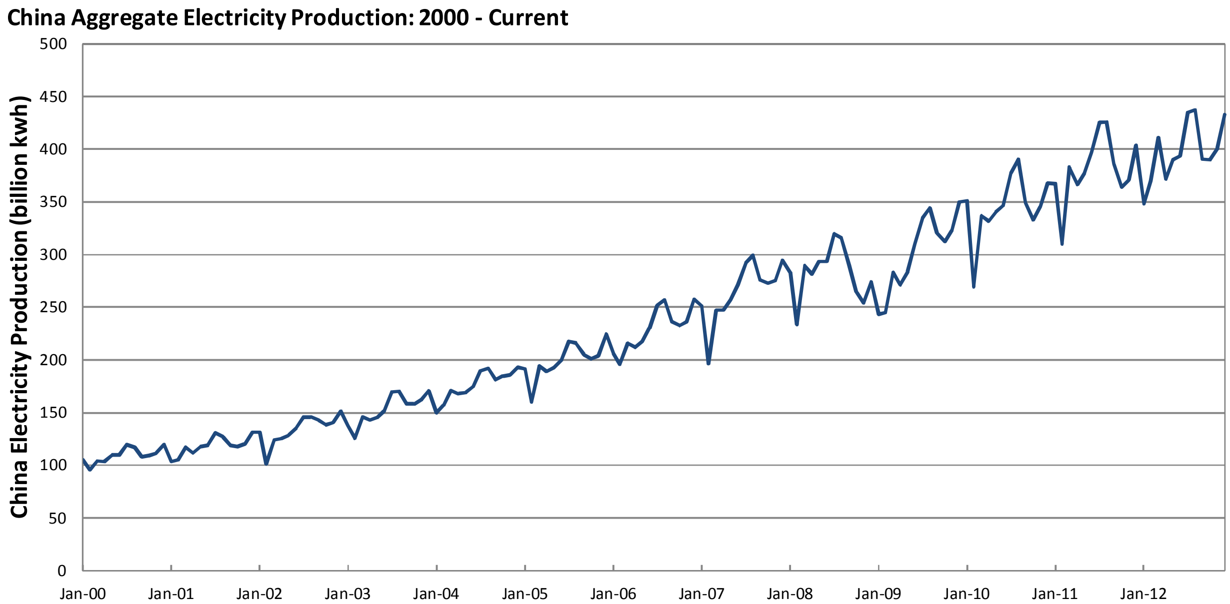
China's Shanghai A-Share Stock Price Index: Jan 2008 to Feb 2013

The stock market is not the only indication that the Chinese economy might be improving. Aggregate financing precedes economic activity in the form of investment, capital expenditure and spending. It is worth noting that aggregate financing in China was a monthly record in January 2013.

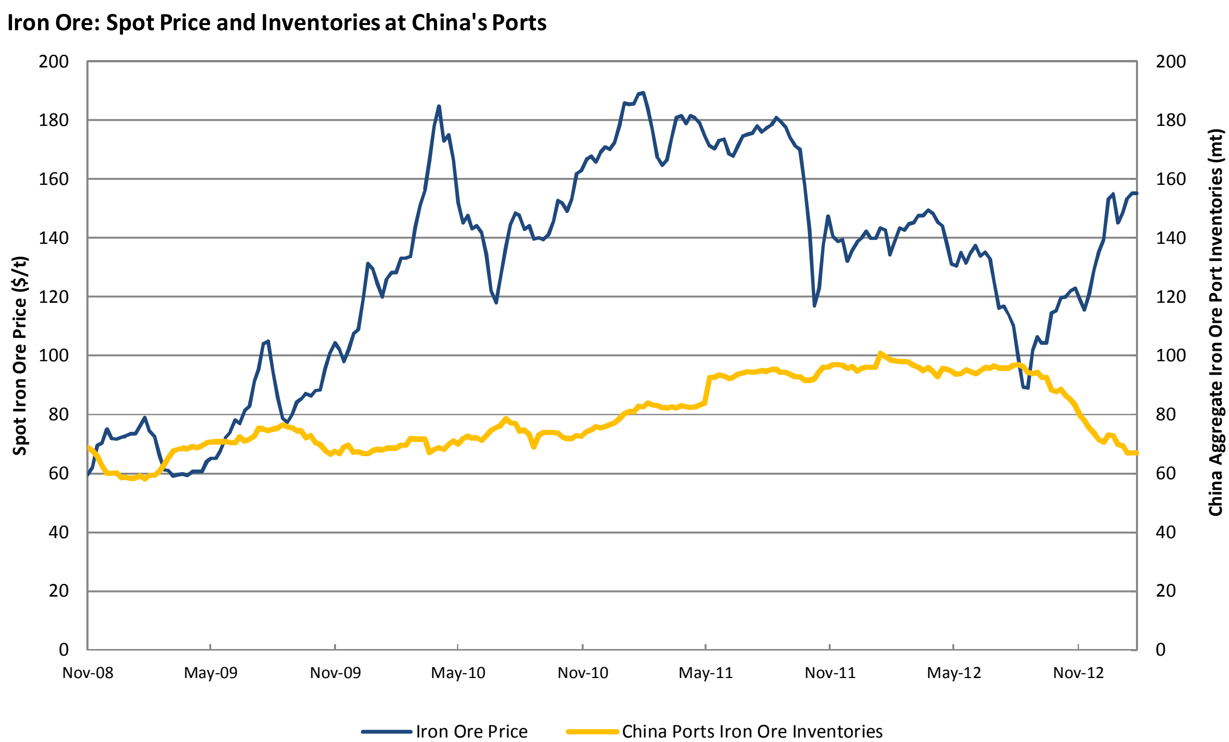
China Aggregate All System Financing: 2002 - Current



Electricity usage in China has also picked up recently.

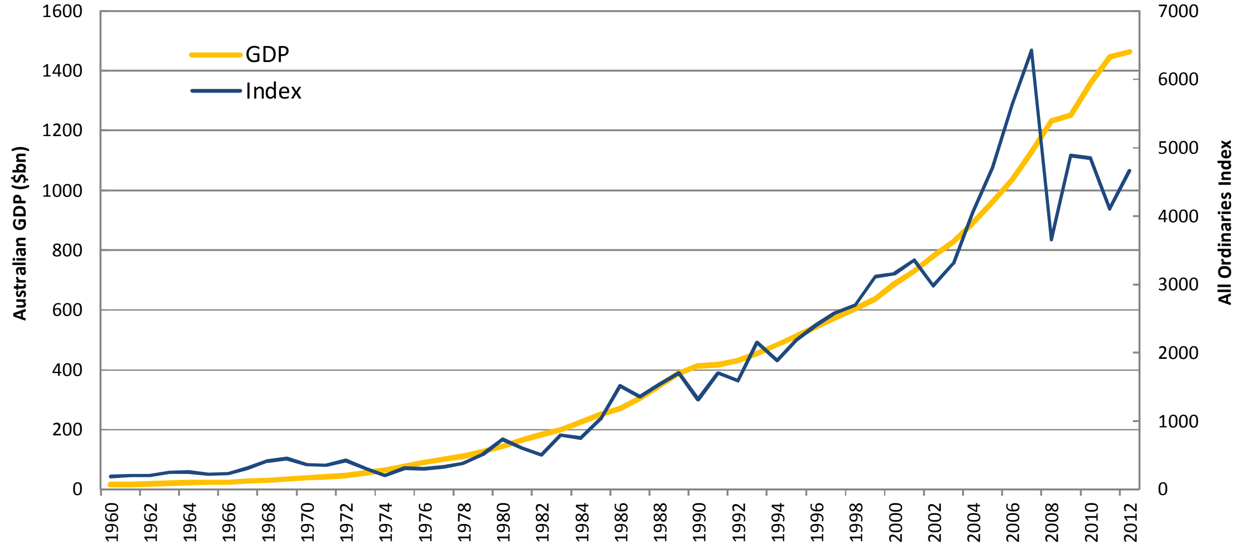


Iron ore prices have rebounded roughly 80% from their September 2012 lows. This has occurred despite inventories at China's ports falling over 30% in the same period.



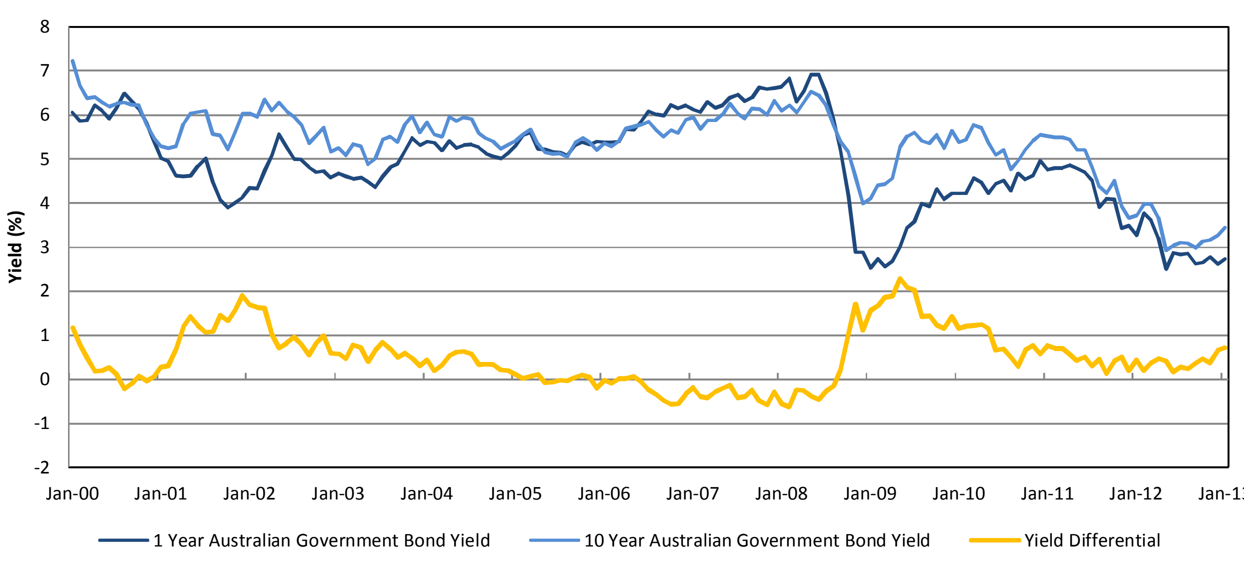
To the extent these indicators demonstrate a pickup in economic activity, the ramifications for Australia are significant. GDP growth in Australia has been very strong over the last five years. The earnings growth of Australian corporates has not been reflected in the stock market. If some of the key concerns for Australia's major trading partners, of which we think China is the most critical, subside, then we think the Australian stock market is likely to continue rising.

Australian GDP v All Ordinaries Index



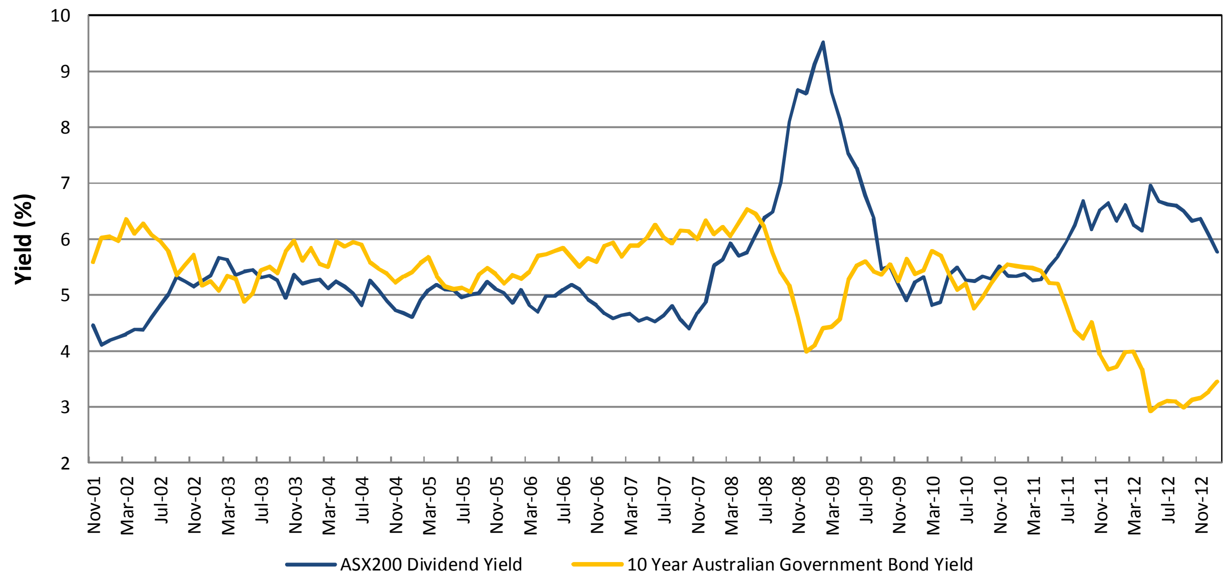
To add to this, real government bond rates have been declining. The diminishing returns offered by bonds encourage investors to look at other assets to generate meaningful real returns. For a bond held to maturity, the only return the owner receives is the yield of the bond at the time of purchase. Current bond prices offer nominal pre-tax returns of circa 3%.

Australian Government Bond Yields

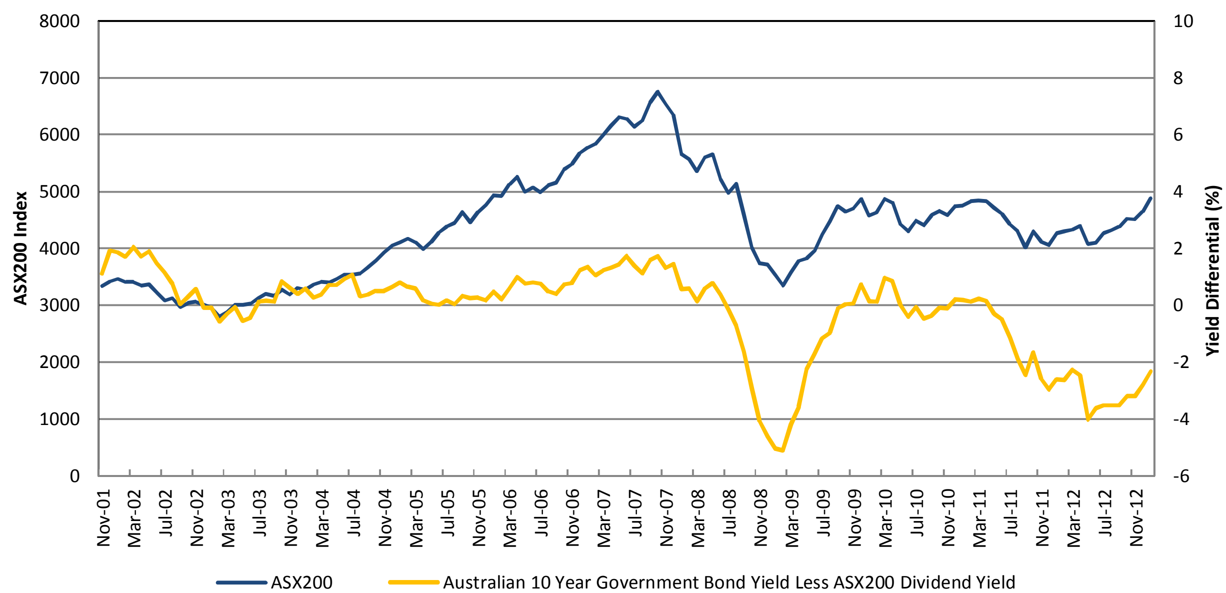


By comparison, equities offer yield through dividends that typically grow over time. When growth is slow or negative, bond yields are often lower than equity yields to adjust for the risk premium investors demand for holding equities over bonds. As the outlook for the economy improves, so does the forecast growth in earnings for companies, and the yield differential narrows. As you can see below, since 2000 the yield on bonds has often been higher than the yield offered by the ASX200. The exceptions to this are during periods of low or negative (recessionary) economic growth and poor investor sentiment. These periods include the bursting of the internet stock bubble in 2002-03, the Global Financial Crisis in 2008-09 and the recent Sovereign Debt Crisis / China slowdown.

ASX200 Dividend Yield vs 10 Year Australian Government Bond Yield



ASX200 Performance vs Bond/Equities Yield Differential



We draw the conclusion that as investor sentiment towards equities improves we expect the yield differential to narrow. China's economic growth appears to have stabilised. This will have a positive impact on expectations in relation to corporate earnings in Australia. Various sectors within the Australian economy seem to have bottomed and are recovering. These are the sectors that we are looking to gain exposure towards in the Fund. While cognisant of the impediments to GDP growth that are likely to appear in 2014, in the medium term we think equity markets are likely to continue to rally. The Fund provides us with the flexibility to hedge and reduce our market exposure when and where we consider it appropriate to deliver strong risk adjusted returns for our investors. There will continue to be pockets of underperformance and weakness which the Fund will also look to take advantage of to generate alpha for our investors.

Interested wholesale investors are encouraged to download a copy of the Information Memorandum from the website, www.auscapam.com.

We welcome any feedback or comments you have. Please direct them to info@auscapam.com.