



## Auscap Long Short Australian Equities Fund Newsletter – March 2015

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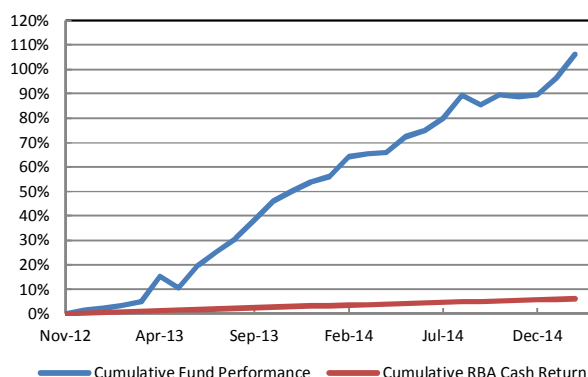
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**Welcome**

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 financial anchoring, the investing bias that can lead to placing too much importance on past price information.

**Fund Performance**

The Fund returned 4.90% net of fees during February 2015. This compares with the benchmark return of 0.17%. Average gross capital employed by the Fund was 108.0% long and 30.7% short. Average net exposure over the month was +77.3%. At the end of the month the Fund had 30 long positions and 9 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, healthcare, consumer staples and energy sectors.



**Fund Returns**

Period	Auscap	Benchmark
February 2015	4.90%	0.17%
Financial Year to date	17.95%	1.64%
Calendar Year to date	8.73%	0.38%
Since inception	106.19%	6.03%

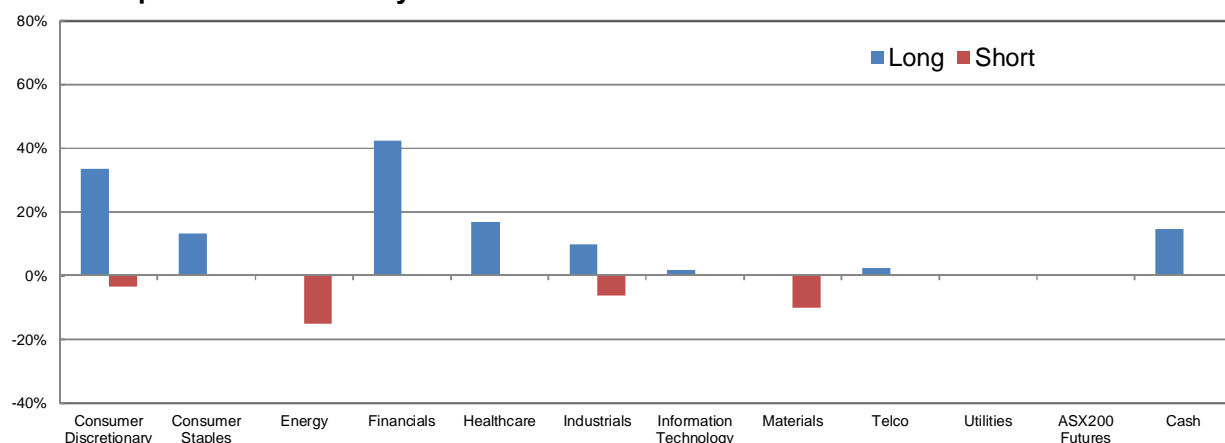
**Fund Exposure**

February 2015 Average	% NAV	Positions
Gross Long	108.0%	29
Gross Short	30.7%	10
Gross Total	138.7%	39
Net / Beta Adjusted Net	77.3%	50.9%

**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					17.95

**Sector Exposure - 28 February 2015**



## The Power And Danger Of Anchoring

In 1974, Amos Tversky and Daniel Kahneman asked a group of people to estimate the percentage of African countries in the United Nations<sup>i</sup>. Prior to providing an answer, each subject witnessed the spin of a roulette wheel that was supposedly random, but had actually been programmed to land on either 10 or 65. When the roulette wheel landed on 10, the median estimate for the group was 25%. When the roulette wheel landed on 65, the median estimate for the group was 45%<sup>ii</sup>. The study demonstrated that humans tend to rely too heavily on the first piece of information offered when making decisions, even if that piece of information is irrelevant. This cognitive bias is referred to as anchoring.

Many further studies confirmed the effect, whether it was estimating the length of a whale or the height of the tallest redwood tree. Anchoring has even been shown to influence decision making involving willingness to pay on a range of products or calculating the value of a car<sup>iii</sup>. During decision making an initial piece of information anchors the subsequent judgements. People are prone to make insufficient adjustments towards the right answer even if they are provided with an obviously high or low initial number<sup>iv</sup>. Perhaps more importantly for finance purposes, empirical evidence suggests that anchors that have informational relevance to the task make people more susceptible to the effect<sup>v</sup>.

We frequently witness, and try not to be affected by, the power of anchoring in investment decision making. Anchoring in finance terms refers to basing investment decisions, partly or entirely, on previous known facts or stock prices, even if those known historical facts or stock prices are irrelevant for assessing the current facts or calculating current values. In other words, investors are influenced in their investment decisions by the recent price history of a particular security, even if this price history has no significance in estimating the company's current worth.

We have noticed with interest the recent commentary on the iron ore market. Iron ore has been in a corrective phase for the past four years, as seen in the chart below. At the time of writing the benchmark iron ore price is just under US\$60 a dry metric tonne landed in Qingdao, China and the Australian dollar is trading at approximately 77 US cents.

### Iron Ore Price: 2011 to 2015

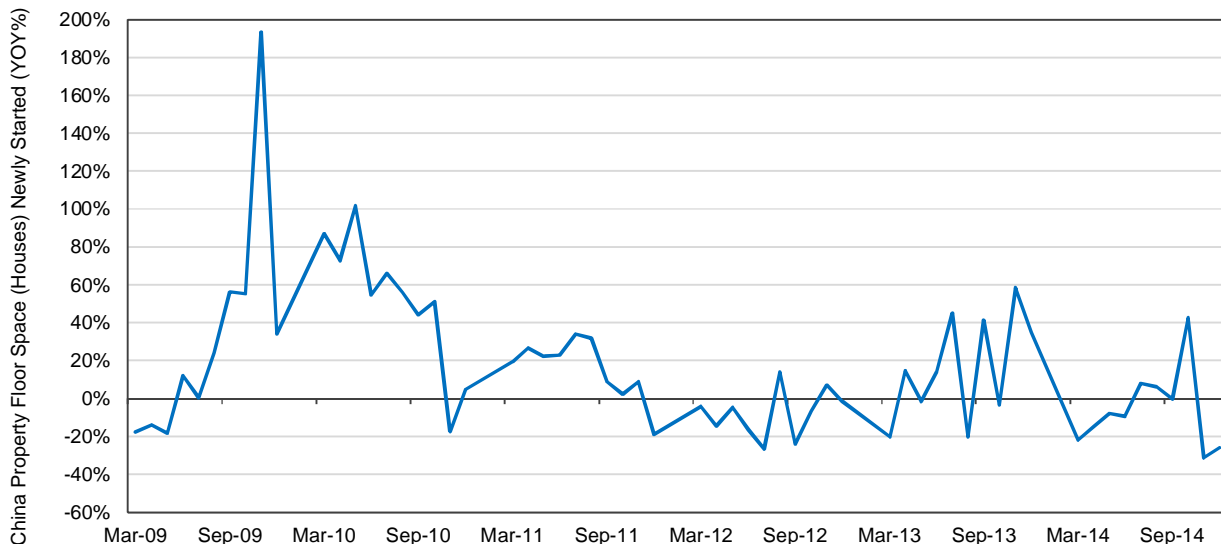


Source: Bloomberg

Many analysts appear reasonably bearish in their views on the supply and demand equation. We have collated below a number of the key facts outlined by these bearish commentators in recent reports in relation to *future* demand and supply.

- Iron ore supply is likely to continue to increase, with the major producers adding around 300 million tonnes of low cost supply to the market in the next few years. This is almost twice the annual production of Fortescue Metals (FMG), the world's fourth largest iron ore miner. In 2012, global production of iron ore was 1,850t.
- Less supply has come out of the market as a result of the falling iron ore price than was expected to be the case. This has mainly been a function of the higher cost miners dramatically reducing their cost base, which has been aided by the fall in the oil price. The price of oil is particularly relevant to the small miners who rely more heavily on oil-intensive mining and transportation (such as trucking ore to ports). Mount Gibson Iron (MGX), Atlas Iron (AGO) and even Fortescue Metals referred specifically to lower fuel and oil prices as one of the reasons driving cash costs down in the 1<sup>st</sup> half FY15 results. Assistance from governments, whether through subsidies or reduced royalties, has also lowered cash costs for the higher cost miners.
- Demand in China is sluggish, with the property sector currently experiencing declining house prices. This is evidenced by the fact that in January 2015, 69 of 70 cities surveyed experienced a year on year decline in residential house prices and 67 of the 70 experienced a decline in residential apartment prices.
- Forward indicators, such as declining housing starts in China over the last 12 months, are indicating that demand for steel, and hence iron ore and coal, is likely to be flat or negative in 2015 (see chart below).
- There is persistent oversupply and overcapacity in steel production in China. However any new stimulus from the Chinese Government is unlikely to be directed towards property and infrastructure development in the same way that it has been in the past.
- The likely continued deterioration in Australia's terms of trade will have a negative effect on the AUD/USD cross. A similar situation is facing the Brazilian real, the world's other major iron ore supplier which is also experiencing a decline in its terms of trade. In 2015, Australia and Brazil are expected to be responsible for over 50% of the world's production of iron ore, representing more than 70% of the global seaborne trade.

**China Property - Floor Space of Houses Newly Started**

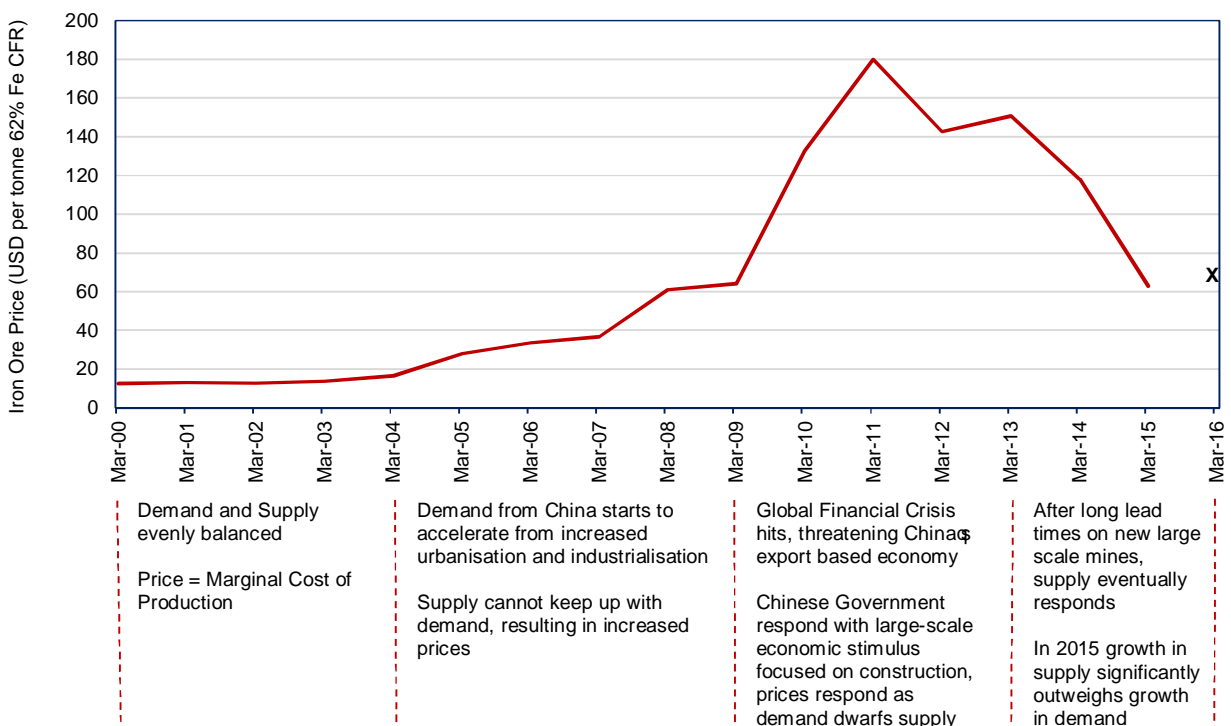


These facts have led to widespread bearishness amongst those analysing the iron ore market. To us, they presently appear to provide a reasonable basis for exercising caution in relation to price expectations for the commodity. What we find surprising though is the price forecasts that have been made in the context of this bearish analysis (irrespective of whether the analysis is correct or not). Most forecasts that we have seen predict an iron ore price in the \$60-\$75 per tonne range in coming years, a price range which sits **above** the spot price. Further, given the likely deterioration in Australia's terms of trade, the consensus medium term outlook for the Australian dollar appears to be circa 70 US cents. In other words, the bears are predicting a significant rise in the Australian dollar iron ore price over the next few years.

We would suggest that were it not for the recent price history of iron ore, the price expectations from the bears would be considerably lower. Price expectations appear to be anchored to this price history (which suggests that \$60-\$75 is low), despite the expectation that low cost supply will flood the market and dwarf demand growth in the next few years. The question we ask is whether expectations change if we eliminate the reference points? Let's assume we delete the iron ore chart above and that we did not reveal the current price of iron ore. Instead we simply provide the facts stated above. We feel it is highly unlikely that anyone would conclude that the price of iron ore is heading higher in the short to medium term. But the facts are not taken in isolation. They are taken in the context of the recent price movements of the commodity in question and it appears that anchoring is most certainly present. The iron ore price may indeed head higher in the medium term if the demand and supply facts turn out differently. However, estimating a higher-than-spot iron ore price in forecasting earnings based on **these** facts appears fraught with danger.

Further, we wonder whether the more price points one has, and the more current price points deviate from the average, the greater the power of the recent past to act as a reference point for the investment decision making process. Could the frequency of pricing information lead to it being attributed greater importance? Let's assume that instead of the price points above, we provide just one price point at the start of March each year and a description of the iron ore market in a few broad categories. The chart might look something like this:

**Iron Ore Prices: 2000 - 2015**



We would suggest that the anchoring effect is less powerful with fewer recent data points, and that armed with less price information the facts start to assume greater significance. We certainly don't think an increased focus on the daily or even intraday pricing will yield greater insights into the likelihood of higher or lower future prices. The question is whether point X represents a bearish forecast given the information stated above? We suggest that it represents a reasonably optimistic expectation given the known facts.

What makes anchoring incredible is the difficulty in avoiding it. Professionals across different industries, from car dealers to estate agents to legal professionals, all demonstrated that they were significantly influenced by anchoring in estimating car values, real estate values and sentencing decisions respectively, despite their specific knowledge in these areas<sup>vi</sup>. The anchoring effect was not reduced by offering payoffs, nor was it eliminated by providing forewarnings about the risks of anchoring<sup>vii</sup>. In other words, people have been found to be susceptible to anchoring even when they are trying to explicitly avoid the effect.

Anchoring in investing can be equally hazardous. Presented with a constant stream of prices that **should** have some relationship to the value of an asset, investors face the risk of giving these prices more meaning than they deserve. At Auscap we constantly focus on trying to remain as objective as possible in assessing the facts associated with any investment decision. It is our view that focusing too much on past price action can be to the detriment of the investor and can heighten the risk that anchoring will negatively affect the investment process.

***If you do not currently receive the Auscap Newsletter automatically, we invite you to register.*** To register please go to the website [www.auscapam.com](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](http://www.auscapam.com/information-memorandum). We welcome any feedback, comments or enquiries. Please direct them to [info@auscapam.com](mailto:info@auscapam.com).

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<sup>i</sup> Tversky, A.; Kahneman, D. (1974). "Judgment under Uncertainty: Heuristics and Biases". *Science* **185** (4157): 1124-1131. doi:10.1126/science.185.4157.1124.

<sup>ii</sup> The answer is 28% as of July 2011 (54 of 193 member states), [www.wikipedia.org](http://www.wikipedia.org)

<sup>iii</sup> Furnham, Adrian; Boo, Hua Chu (2011). "A literature review of the anchoring effect". *The Journal of Socio-Economics* **40** (1): 35-42. doi:10.1016/j.socsc.2010.10.008

<sup>iv</sup> Tversky, Amos; Kahneman, Daniel (1992). "Advances in prospect theory: Cumulative representation of uncertainty". *Journal of Risk and Uncertainty* **5** (4): 297-323. doi:10.1007/BF00122574.

<sup>v</sup> Furnham & Boo, above n(iii)

<sup>vi</sup> Ibid

<sup>vii</sup> Ibid