Auscap Asset Management

Auscap Long Short Australian Equities Fund Newsletter – November 2013

Welcome

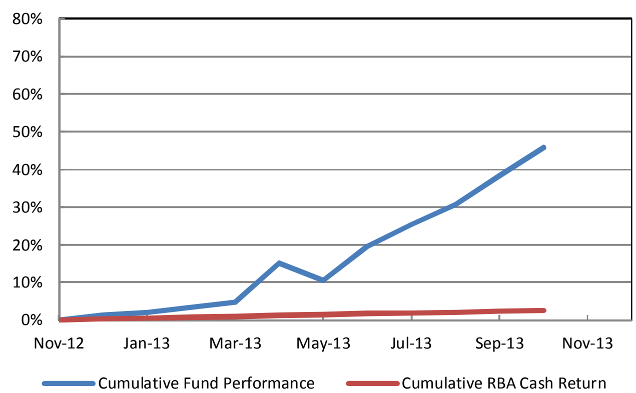
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (ìFundî) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we look at equities and whether they are currently expensive. Is it a good time to buy? Is it a good time to sell? We look at a number of absolute and relative measures to draw a few conclusions.

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 for sophisticated investors to the Fundís Information Memorandum, is available at our website www.auscapam.com. Enquiries can be directed to info@auscapam.com.

Fund Performance

The Fund returned 5.46% net of fees during October 2013. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 122.8% long and 24.3% short. Average net exposure over the month was +98.4%. At the end of the month the Fund had 24 long positions and 7 short positions. The Fundís biggest exposures at month end were spread across the consumer discretionary, financials, healthcare and telecommunications sectors.



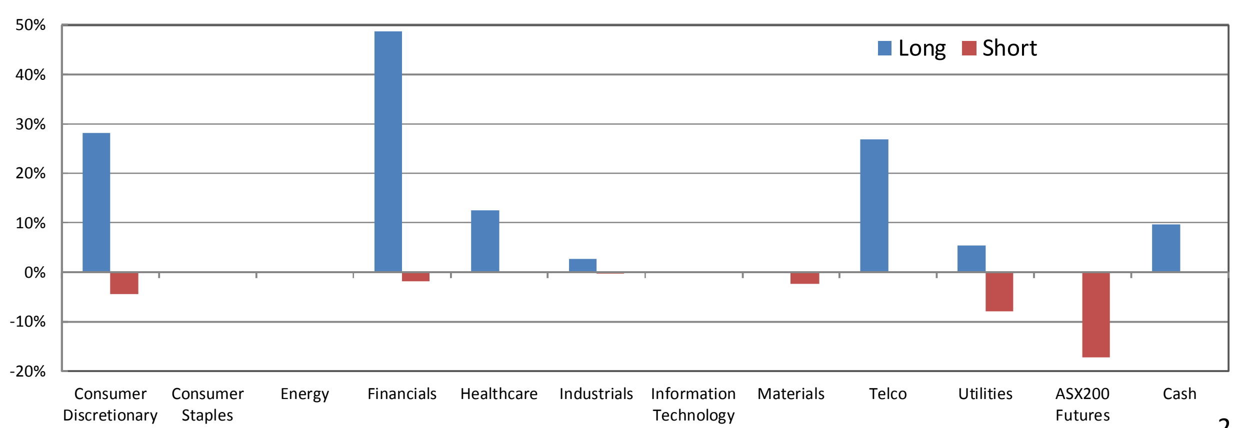
Fund Returns

Period	Auscap	Benchmark
October 2013	5.46%	0.21%
Financial Year to date	21.87%	0.44%
Since inception	45.90%	2.60%

Fund Exposure

October 2013 Average	% NAV	Positions
Gross Long	122.8%	26
Gross Short	24.3%	7
Gross Total	147.1%	33
Net / Beta Adjusted Net	98.4%	74.2%

Sector Exposure - 31 October 2013



The Bears Have No Shares: Are Equities Expensive?

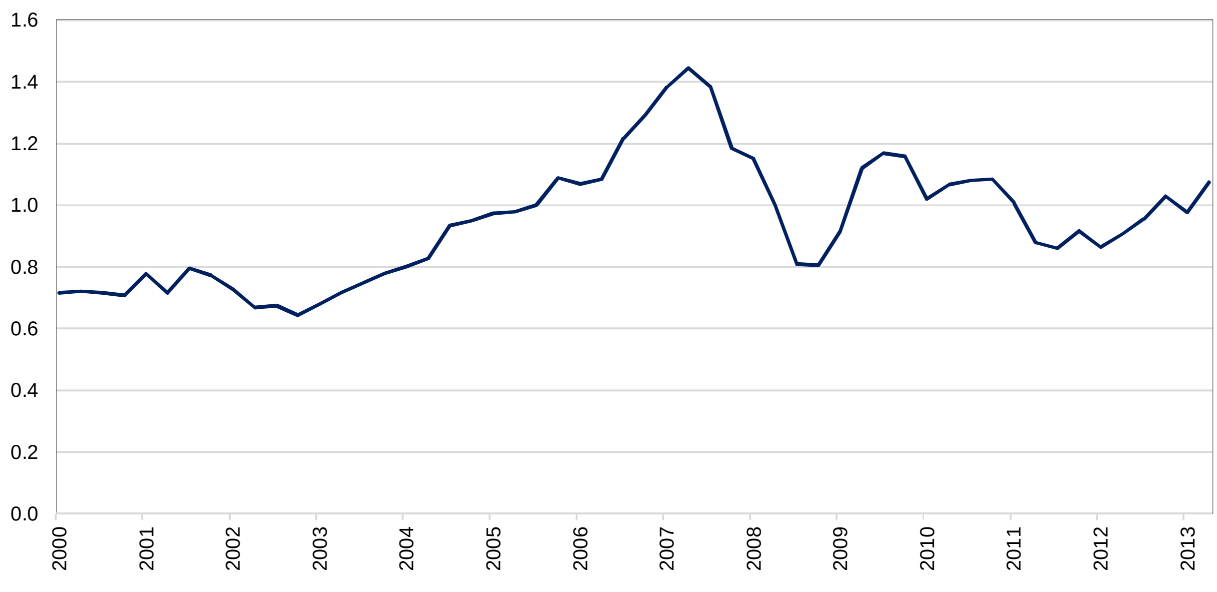
"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February."

Mark Twain

We couldnõt agree more with this Mark Twain quote. While October has historically been seen as a turbulent month, we would suggest that any month poses a risk for those speculating on stocks as opposed to those investing in businesses. As Warren Buffett put it, ñIf you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutesò.

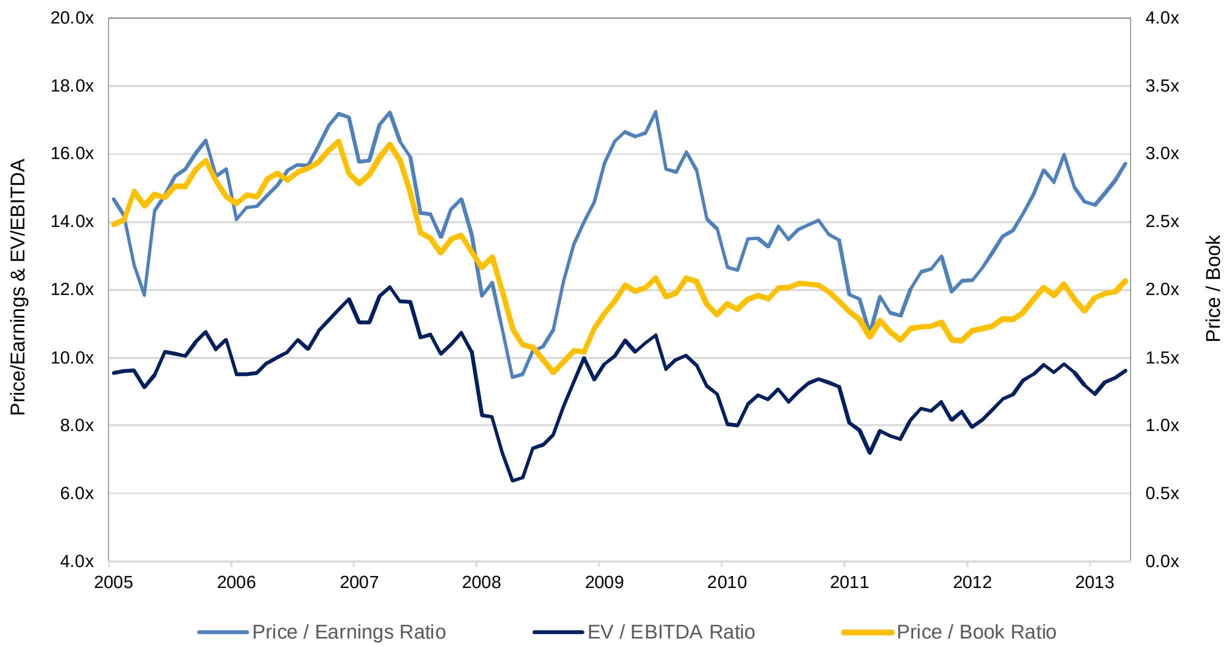
Investors are intuitively questioning whether it is too late to invest in equities because of the marketõs strong performance over the past year and a half. We can understand this quandary. The All Ordinaries Accumulation Index has increased 36.9% in the last 18 months and 27.6% in the last 12 months. We evaluate the market, sectors and stocks according to different measures, both quantitative and qualitative in nature. At a macro level, it is no longer possible to argue that the market is cheap in absolute terms by historical standards. Indeed the ñre-rating of equitiesò has occurred. We attempt to show this graphically below. However, this does not lead us to the conclusion that the market is expensive. In fact, relative to other asset classes, we continue to believe that equities are a relatively attractive place to invest capital. Certainly we do not believe that our core positions are expensive, and we hold a positive view on the returns offered by these investments going forward.

All Ordinaries Market Capitalisation / Gross National Income



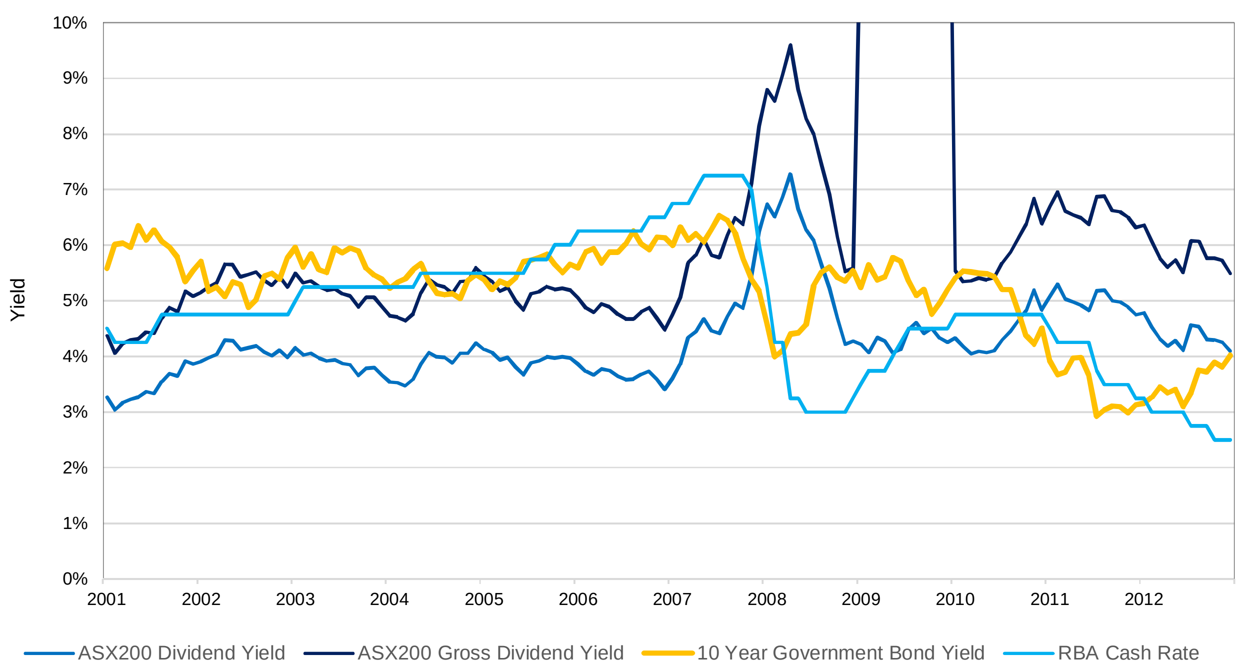
In absolute terms, equities appear priced within, albeit towards the upper end of, the normal trading range of measures we typically analyse. This includes the chart above, the All Ordinaries Market Capitalisation divided by Gross National Income, as well as the more frequently discussed ratios presented below. We use Gross National Income as the denominator because, unlike Gross Domestic Product, it includes the profits of Australian owned companies operating abroad. While there are undoubtedly some risks to growth, these are somewhat known, can be assessed over time as circumstances change and do not impact on all sectors within the economy in a uniform manner.

ASX200 - Absolute Measures of Value



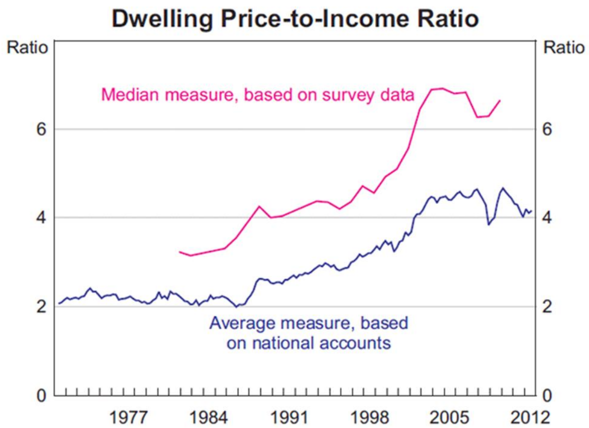
Equities still appear to be relatively attractive compared to alternative asset classes. Alternative asset classes include cash or term deposits, bonds and property. The gross dividend yield on the ASX200 is still significantly above the cash rate and the yield offered by 10 year Government bonds.

Yield on Major Australian Equities and Cash Instruments

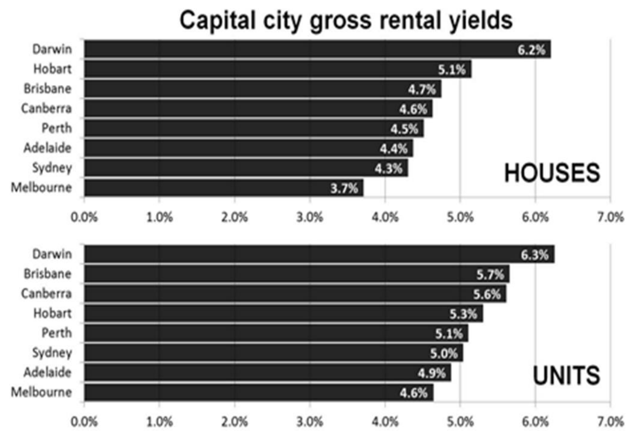


Given the headwinds facing economic growth in the near future, associated with the high likelihood of capital expenditure on mining falling over the next few years, it is difficult to see cash rates rising quickly.

Residential property Dwelling Price to Income ratios have risen significantly over the last three decades. Gross rental yields on a national capital city basis were circa 4.2% for houses and 5.0% for units as of June 2013.



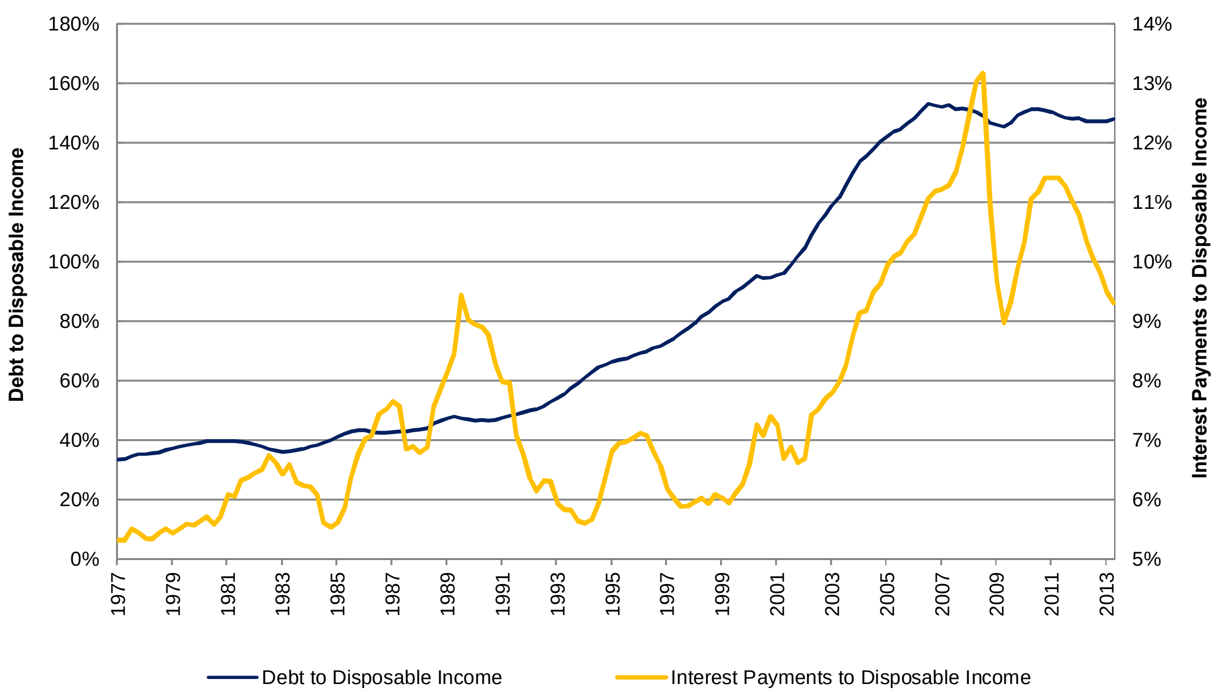
Source: Ryan Fox & Richard Finlay, *RBA Bulletin - December Quarter 2012*



Source: Tim Lawless, ñThe gradual rebound of residential rental yieldsò, *Property Observer*, June 2013

Household leverage has also increased significantly over recent decades. We are not residential property experts and therefore will not draw any conclusions from these observations.

Household Leverage Ratios



Clearly any relative value argument is one that requires caution. It may simply point to the expensive nature of the alternative asset classes. In addition, conditions change over time and the domestic economy is over-exposed to a few critical sectors. We continually evaluate our portfolio and the hedging we have in place as these economic circumstances change.

We invest in companies where we see real cash flows and a history of delivering strong returns on invested capital. We certainly have no interest in speculating on companies with no earnings and market capitalisations only matched by the hopes and expectations of stakeholders. It is often hardest to avoid speculating at exactly the wrong time. Stocks that have tripled in value in a short period of time tend to demand attention. We try to have moderate expectations for improvements in earnings in the stocks we own so that we can't be overly disappointed. We look for attractive risk adjusted returns from our equity investments. We believe that paying modest prices for conservative forecast earnings are likely to produce solid investment returns over time.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to www.auscapam.com and follow the registration link.

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

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