



Auscap Long Short Australian Equities Fund Newsletter – October 2013

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Welcome

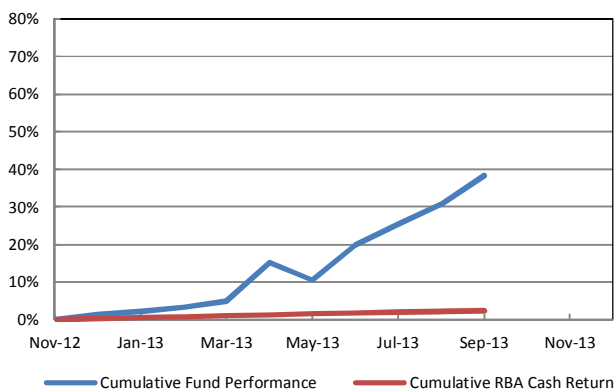
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (“Fund”) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we look at an alternative notion of the margin of safety concept, and why we think an investment approach that considers the macroeconomic and industry environment affords us some protection against loss of investment capital.

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 Fund’s Information Memorandum, is available at our website www.auscapam.com. Enquiries can be directed to info@auscapam.com.

Fund Performance

The Fund returned 5.84% net of fees during September 2013. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 109.9% long and 23.5% short. Average net exposure over the month was +86.4%. At the end of the month the Fund had 20 long positions and 8 short positions. The Fund’s biggest exposures at month end were spread across the consumer discretionary, financials, healthcare, telco and materials sectors.



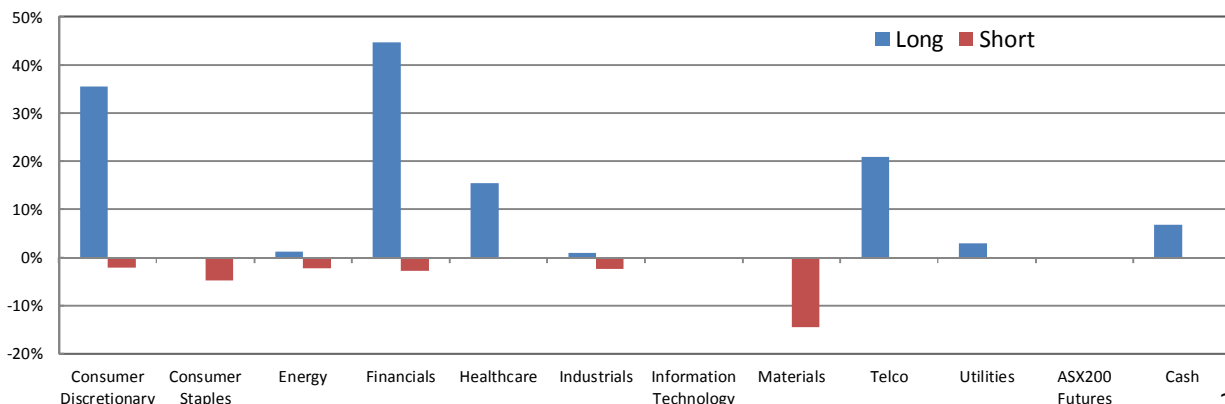
Fund Returns

Period	Auscap	Benchmark
September 2013	5.84%	0.21%
Financial Year to date	15.56%	0.65%
Since inception	38.35%	2.38%

Fund Exposure

September 2013 Average	% NAV	Positions
Gross Long	109.9%	22
Gross Short	23.5%	9
Gross Total	133.4%	31
Net / Beta Adjusted Net	86.4%	64.7%

Sector Exposure - 31 Sep 2013



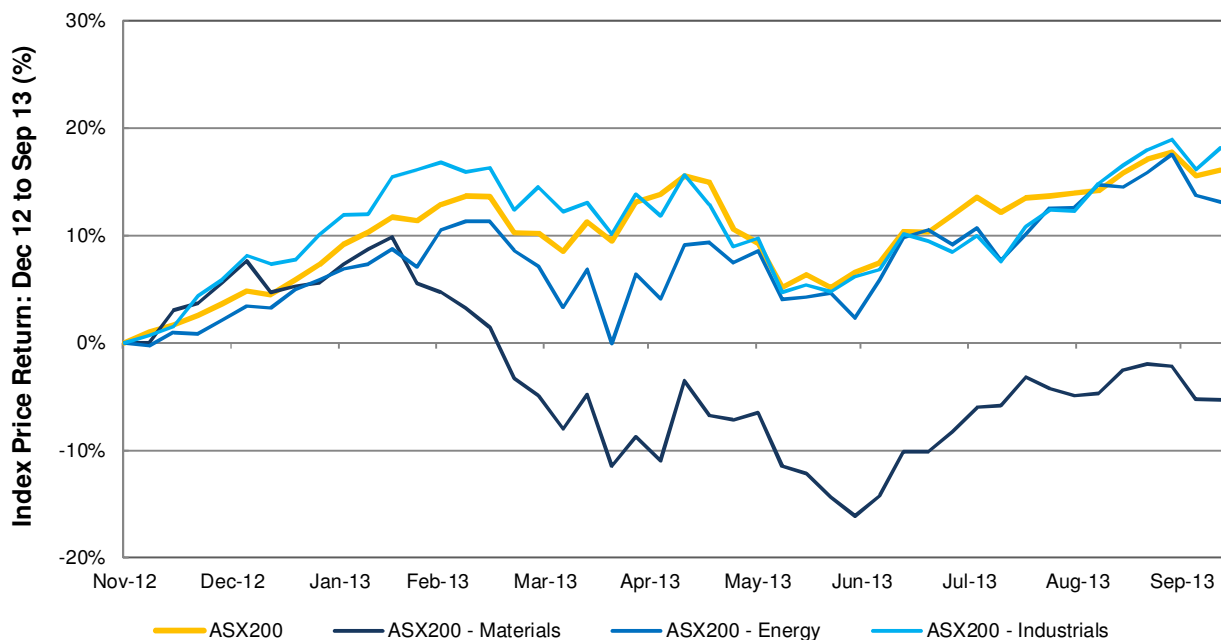
An Alternative Notion of Margin of Safety

We take a fundamental, largely value based, approach to our long term investments. As part of this approach, we look at not just company details, but the dynamics in the economy and the specific sector that a particular company participates in. We would rather invest in companies operating in parts of the economy that have broadly favourable conditions assisting growth and profitability than the converse. To some degree, these favourable economic conditions give us a greater margin of safety in our investment. Company profits might improve because of either improving conditions in the economy, in the sector and/or within the company, preferably all three at once.

Generally a company with economic and industry tailwinds will make an acceptable investment over the medium term irrespective of whether management are actually doing a better-than-average job running the company. There is little doubt that some of the performance of the Fund since inception has been a result of the specific sectors that we have been long and short, and the stocks we have avoided because of negative sector dynamics. Sometimes the stocks you avoid are some of the best investment decisions you make. A brief analysis of our sector exposure over time highlights this fact.

Our decision to avoid investing in commodity driven stocks and companies servicing the commodity sector was based on the assumption that commodity prices would revert to the marginal cost of production from elevated levels over time, posing a risk to the returns generated by a capital intensive sector. The commodity sectors and related industries have generally underperformed the broader market since the start of the year.

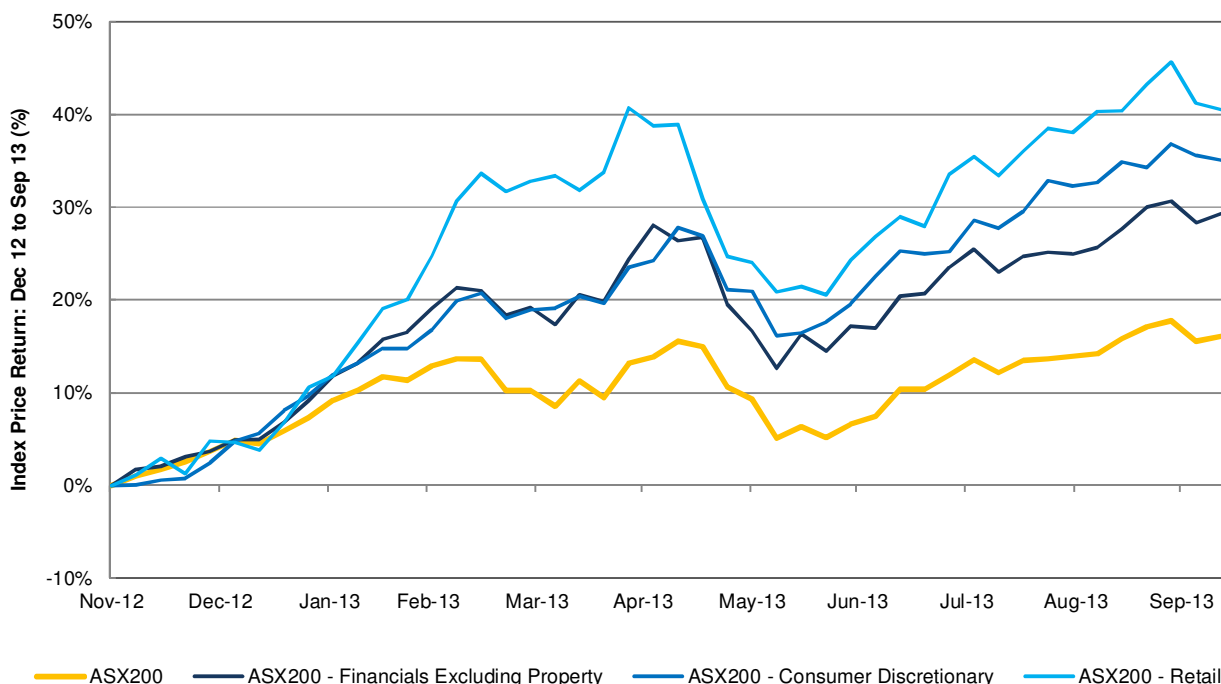
ASX200 v Commodity Facing Sectors



In this type of environment, even the best stock picker may struggle to identify individual names in the materials sector that have generated a reasonable total return for an investor because of the broader headwinds facing commodities as growth in China slows and supply increases faster than demand.

This is in contrast to our view that a slow recovery is underway on the Australian east coast in the financial, retail, building, construction and tourism sectors, driven by improving consumer and business confidence, a lower Australian dollar and low interest rates. We have been, and continue to be, overweight select individual names in these sectors. The success of some of the individual stocks has been driven by a change in economic conditions facing these industries as much as by astute stock picking. While stock picking is very important, stocks may outperform because of a re-rating of the whole sector, rather than the re-rating of the individual stock. For the indices below to perform as well as they have, most of the large stocks in the index will have performed quite strongly over the period.

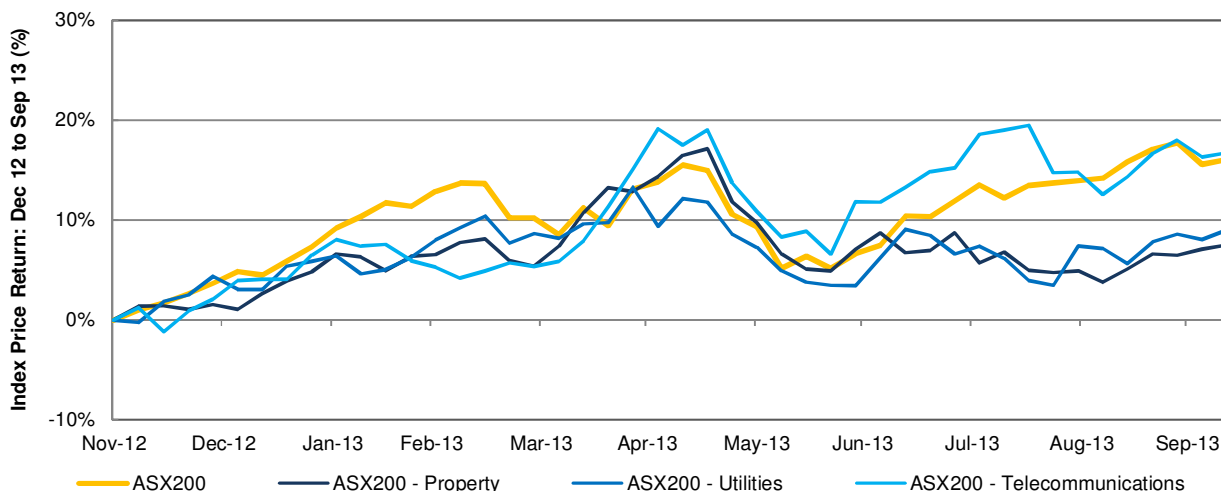
ASX200 v Financials & Consumer Cyclical



We find it useful to have many different reasons for why we consider a sector to be attractive. Given we are, at times, invariably wrong in our thesis, or circumstances and consequently our views change, having a number of macro, sector and company specific reasons for being invested in a position gives us a margin of safety if we are wrong about any single aspect of an investment.

We have been invested in individual names within the relatively defensive telecommunications, infrastructure and property sectors over the course of the Fund. The telecommunications sector has kept pace with the broader stockmarket, a notable achievement for a defensive sector in a rising market, largely due to strong macro and sector tailwinds. The infrastructure, utilities and property sectors have also performed well according to our key metric of delivering strong absolute risk adjusted returns. It should be noted that these charts are merely price charts, rather than total return charts, and do not include any dividends paid over the course of the year. These dividends or distributions should be added to calculate the total return.

ASX200 v Defensive Sectors

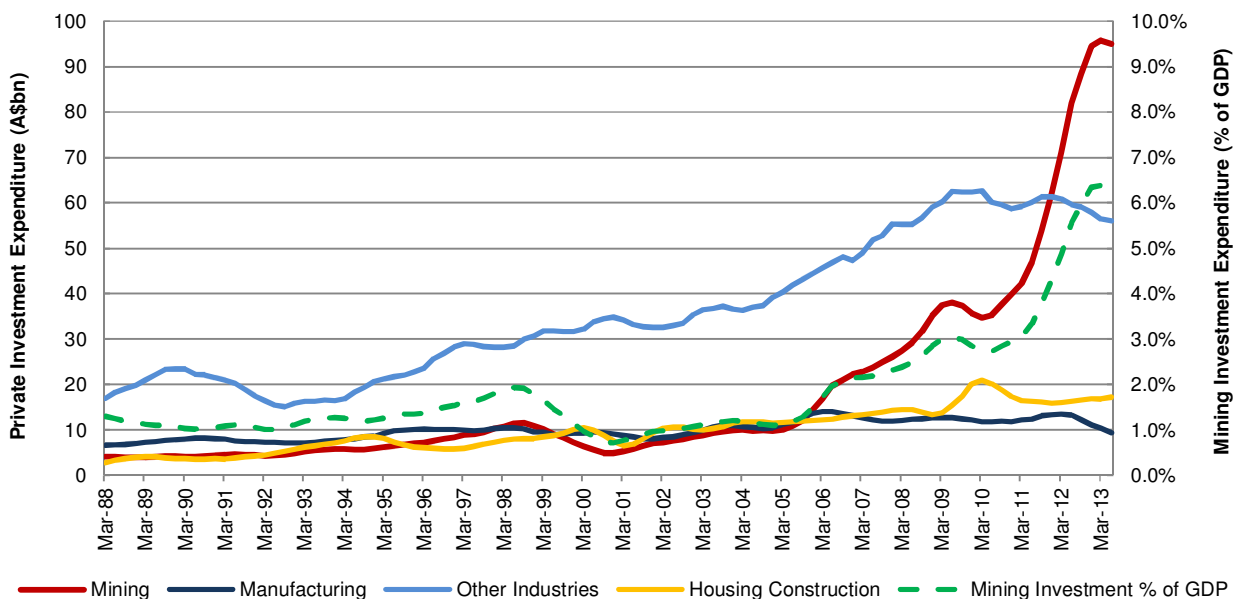


Our Defensive Assets Thesis: December 2012

These defensive positions have generated strong returns despite the fact that we have been clearly incorrect in one aspect of our analysis developed in late 2012. Our thesis in relation to high yielding, defensive asset classes has been relatively straightforward, as we intend to explain below.

The ASX200 has been a very strongly performing stockmarket since 1900, delivering a total return of approximately 11.8% pa to June 2012¹. This compares favourably to the US stockmarket, which has returned 9.5% pa over the same period. Over the last decade earnings have been driven by our exposure to an emerging China and its voracious appetite for resources that has driven both economic investment and Australia’s terms of trade. This has given our GDP a significant boost. Over the coming years we think it is highly likely that commodity prices will revert to their marginal cost and the high level of investment in mining will fall and will not be adequately replaced, at least not in the short term, by investment in other sectors.

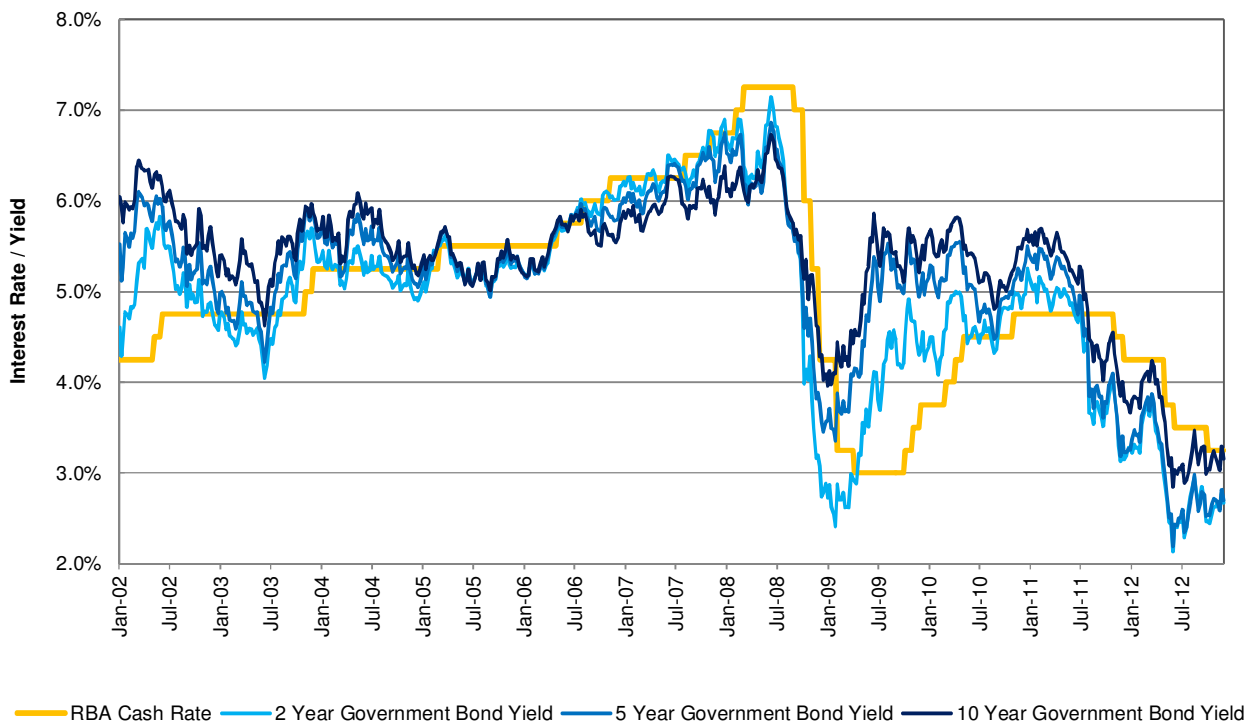
Sector Contributions to Private Investment



If you combine these factors with relative austerity at the Federal and State Government level, as they try to get budget deficits under control, the conclusion we draw is that economic growth over the next 3–5 years is likely to be considerably lower than what it has been over the last decade. If this is the case, we would consider 9-12% a very acceptable total return on any real asset that we consider to have relatively low risk. In late 2012 there were many defensive assets trading at or less than their Net Tangible Asset (NTA) backing that we purchased that we considered fell into this class. These assets were yielding 6%–9% and we were of the view that this yield was likely to increase at a rate that matched inflation and potentially population growth (3%–5%) over time.

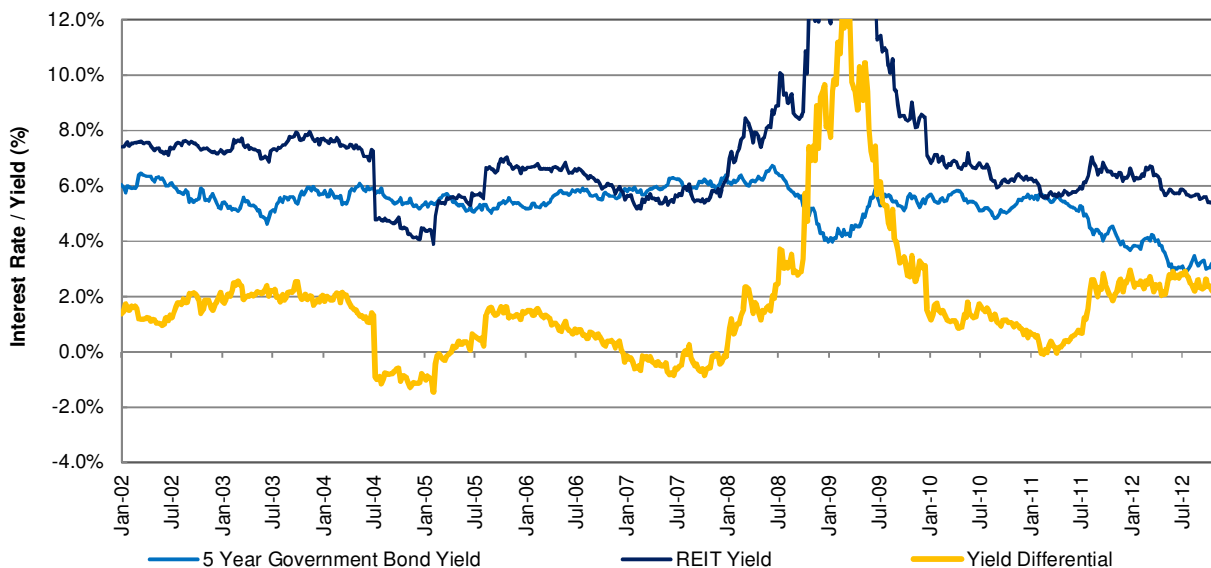
However we considered that there might be further upside to these assets that displayed some bond like qualities. We reasoned that if the economy is going to slow, the RBA Cash Rate should decline and remain at a relatively low rate for a considerable period of time. This would influence bond rates, which should also decline. This should make other bond proxies in the equity market, such as critical infrastructure assets, utilities and commercial and industrial property, relatively more attractive.

RBA Target Cash Rate vs Bond Yields to November 2012



Further, the spread between bond yields and the yield on defensive assets was already quite wide by historical standards. In the absence of an event that would cause another dislocation in financial markets affecting asset prices, such as the Global Financial Crisis, our assumption was that this spread, shown below, should narrow over time. If yields compressed, this would give the holders of these assets an additional capital gain. We will take the listed property sector as our example. We expected the spread between bond yields and property yields to decline as a result of commercial and industrial property values increasing (pushing yields lower).

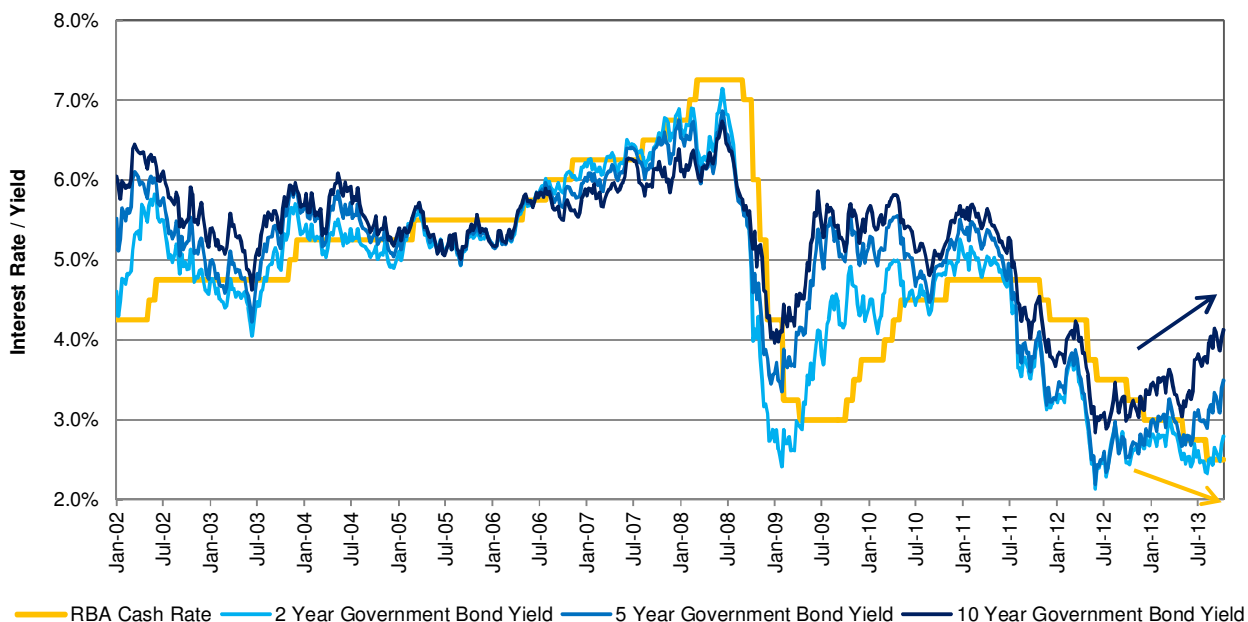
10 Year Government Bond Yield vs ASX200 Property Index Yield
 Period Ending November 2012



Wind Forward: October 2013

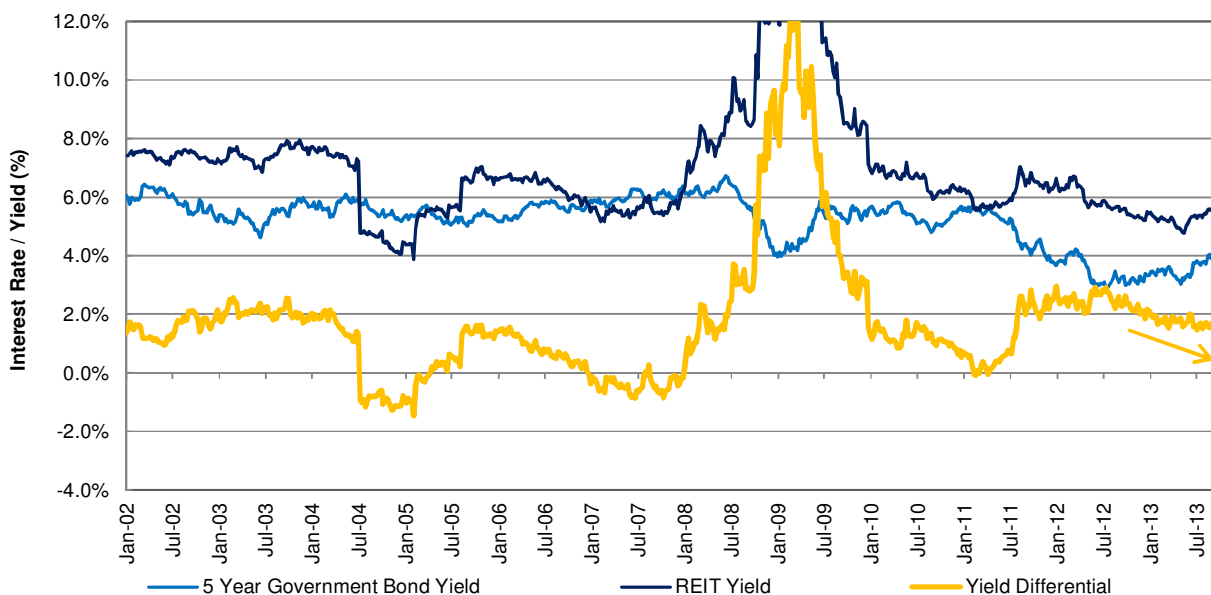
We assumed bond yields were going to stay low given the cash rate was likely to fall. However, despite interest rates falling, with the RBA cutting the cash rate in December, May and August, long term bond yields have rallied over the past 10 months. The main reason for this has been the move in bond yields in the US, which have been affected by the threat of a removal of large scale monetary stimulus, or Quantitative Easing, which involved the Federal Reserve purchasing Treasury and mortgage backed securities. We underestimated the sustained impact of this on the domestic bond market.

RBA Target Cash Rate vs Bond Yields to October 2013



However, the second component of what we considered to be upside to our investment thesis did play out, even though it was not as we expected. Yields have indeed compressed, as seen in the chart below. What we thought may provide us with an additional capital gain, the unusually wide yield differential, has fallen and instead protected our investments against a decline in value.

10 Year Government Bond Yield vs ASX200 Property Index Yield
 Period Ending October 2013



It is important to note that our investment thesis was not based on the direction of bond rates, but on the total absolute return offered by the assets. To date we have been altogether wrong in our thesis that bond rates would remain low for a considerable period of time. However, our thesis that the differential between bond rates and the yield on property assets would compress protected our investment against what might have otherwise been an adverse move in the prices of the defensive assets we owned, driven by a move in bond prices.

We look at the interplay between asset classes, the macroeconomic influences on positions, industry conditions and the specifics of individual companies so that we can invest in stocks which we think have the highest probability of delivering a strong total return to our investors. When a thesis or an assumption is incorrect, we think it is useful to have additional factors working in our favour. These factors provide a margin of safety that lowers the risk of loss of capital. In our view the preservation of capital is the most important aspect of generating strong compounding 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.

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Legal: Henry Davis York

ⁱShane Oliver, "Does long-term share investing still work", August 2012, AMP, <http://www.asx.com.au/education/investor-update-newsletter/201208-does-long-term-share-investing-still-work.htm>