Auscap Long Short Australian Equities Fund Newsletter – August 2015

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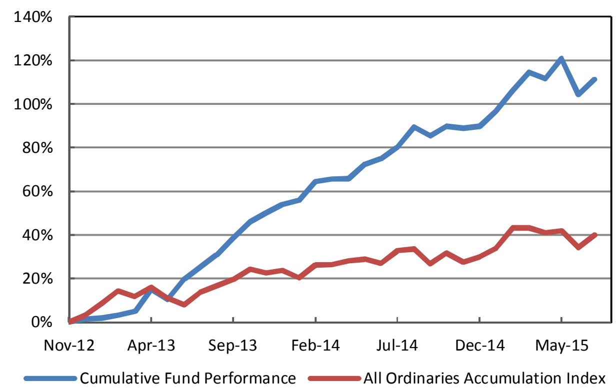
Welcome

Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (ĩFundõ) 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 the demand and supply imbalance in the oil market and whether the recent fall in the oil price represents risk or opportunity.

Fund Performance

The Fund returned 3.46% net of fees during July 2015. This compares with the All Ordinaries Accumulation Index return of 4.23%. Average gross capital employed by the Fund was 108.9% long and 34.1% short. Average net exposure over the month was 74.8%. At the end of the month the Fund had 38 long positions and 14 short positions. The Fundõs biggest stock exposures at month end were spread across the financials, consumer discretionary, healthcare, industrials, energy and materials sectors.



Fund Returns

Period	Auscap	All Ords AI
July 2015	3.46%	4.23%
Financial Year to date	3.46%	4.23%
Calendar Year to date	11.40%	7.69%
Since inception	111.25%	39.96%

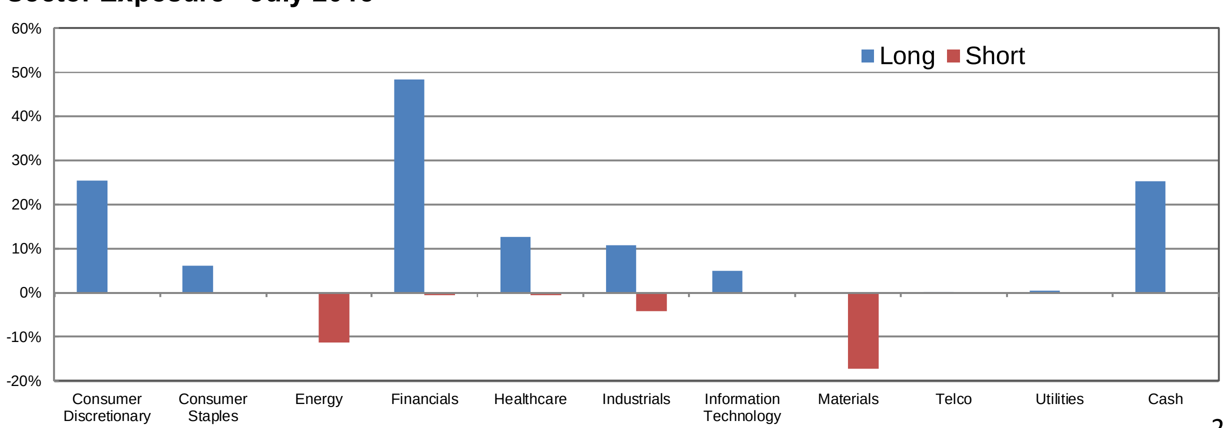
Fund Exposure

July 2015 Average	% NAV	Positions
Gross Long	108.9%	34
Gross Short	34.1%	14
Gross Total	143.0%	48
Net / Beta Adjusted Net	74.8%	44.3%

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												3.46

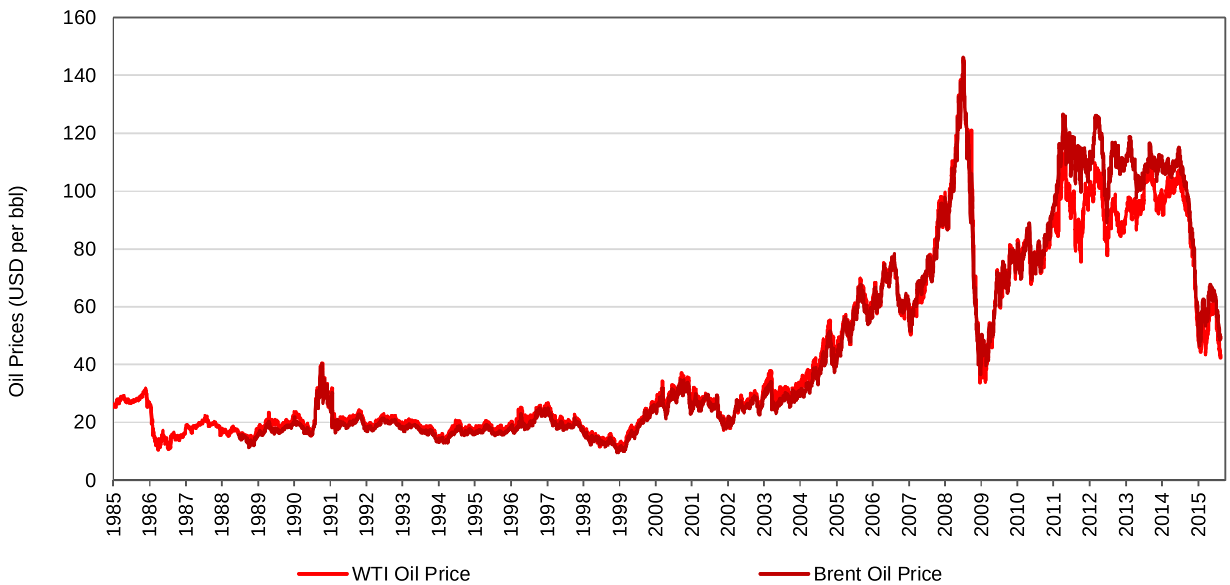
Sector Exposure - July 2015



The Slippery Slope Of Forecasting Oil Prices

We think one of the dangers in any market is to get caught up in group think. Group think has the potential to be dangerous because at the major turning points the majority view is often an incorrect one. At the time of writing, the spot price of brent crude, the world's most traded oil contract and leading global price benchmark for Atlantic basin crude oils, is below US$50 per barrel. Brent crude is a sweet light crude oil that serves as a major benchmark price for purchases of oil around the world. Brent crude is extracted from the North Sea and was originally produced from the Brent oilfield. The world's second most traded oil contract, the West Texas Intermediate, or WTI, is trading at closer to US$40 per barrel. It is a far cry from the US$100+ per barrel both contracts were trading at only a year ago. Prices have declined dramatically in the last few months despite the near consensus view that they should rally. The majority of forecasts we have seen have expected oil to trade north of $70 over the foreseeable future, suggesting that the recent drop in the oil price therefore presents an opportunity to buy the oil companies at attractive prices.

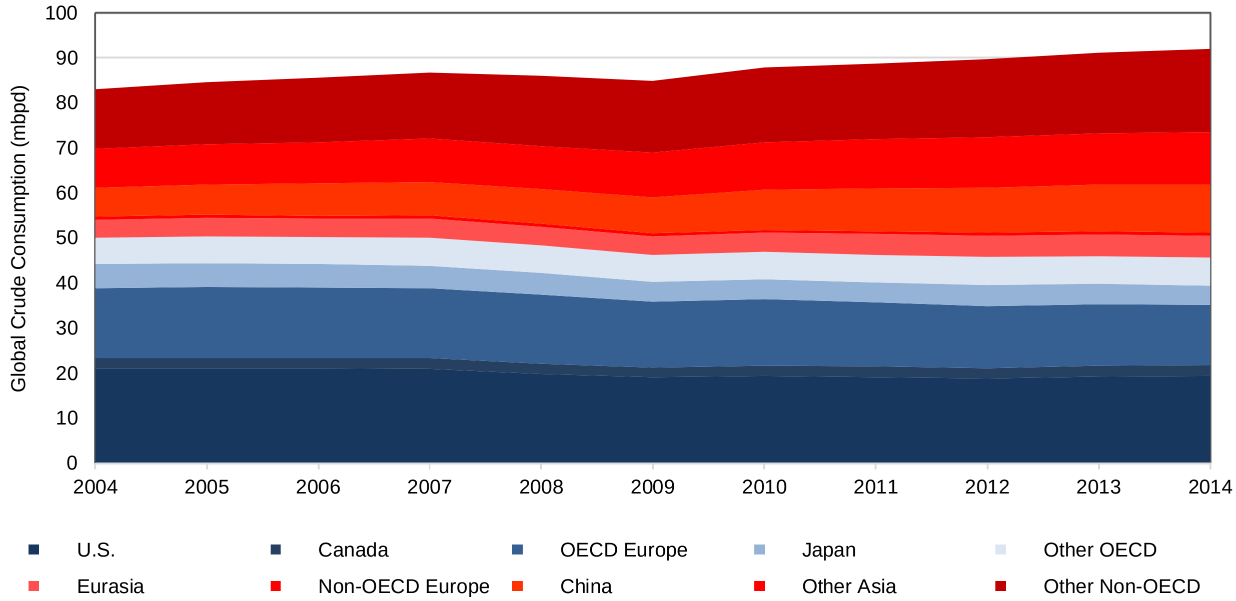
Brent and WTI Crude Oil Prices: 1985 to Present



The common view that oil should shortly trade above $70 per barrel led us to an examination of global supply and demand dynamics. The current situation is that supply is exceeding demand. According to U.S. Energy Information Administration, the 2014 imbalance was over 1 million barrels a day (mbpd), with supply of 93mbpd against consumption of 92mbpd. Such an imbalance could correct itself either through an increase in demand with no corresponding increase in supply, or a decrease in supply.

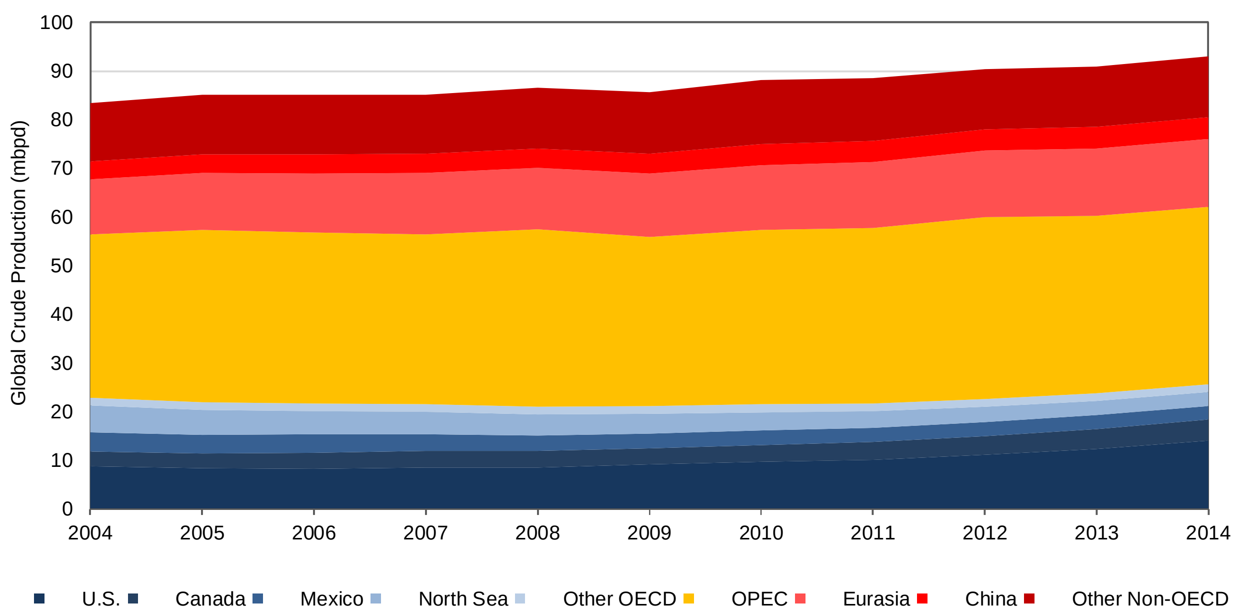
Global consumption has increased by around 10.8% over the last decade. The growth has been far from even. In fact the 34 OECD countries have, collectively, seen a fall in consumption of 8.8% over this period. This is highlighted by the combined blue sections in the chart below. Slow growth, ageing and stagnant populations, the rise of alternative fuels and increasing energy efficiency are cited as reasons for the decline. By contrast, the emerging markets have seen a considerable increase in consumption. Non-OECD countries have witnessed growth of just over 40% through the course of the decade, such that in 2014 non-OECD countries out-consumed the OECD group for the first time in recorded history. China's demand growth has led this increase in consumption, with petroleum consumption increasing almost 66% over the decade. Recent evidence suggests that economic growth in the emerging markets has declined, which may prevent strong growth in global consumption in the coming years.

Global Petroleum Consumption: 2004-2014



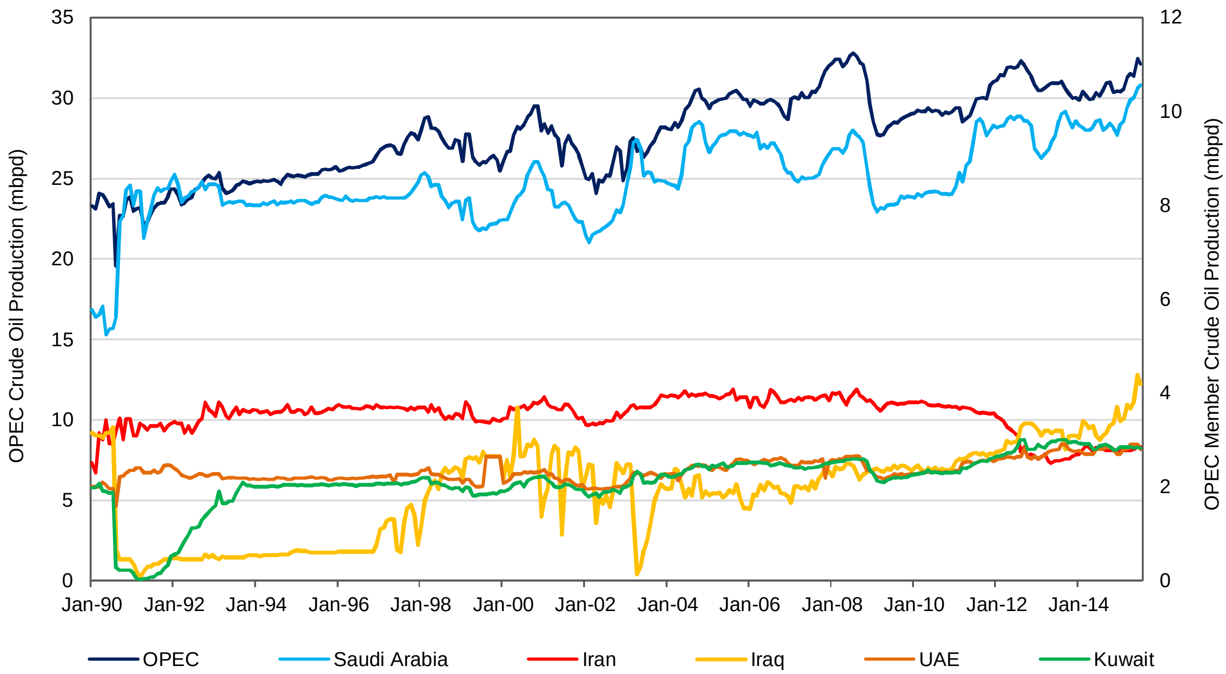
Global production growth has slightly outpaced global demand, with growth of 11.6% over the decade. But 30% of this growth came in 2014 as production out of the US accelerated. The increase in US oil production has been remarkable, with a 60% increase in supply over the last ten years. This compares to an increase in OPEC supply of just 8.6%.

Global Petroleum Production: 2004-2014



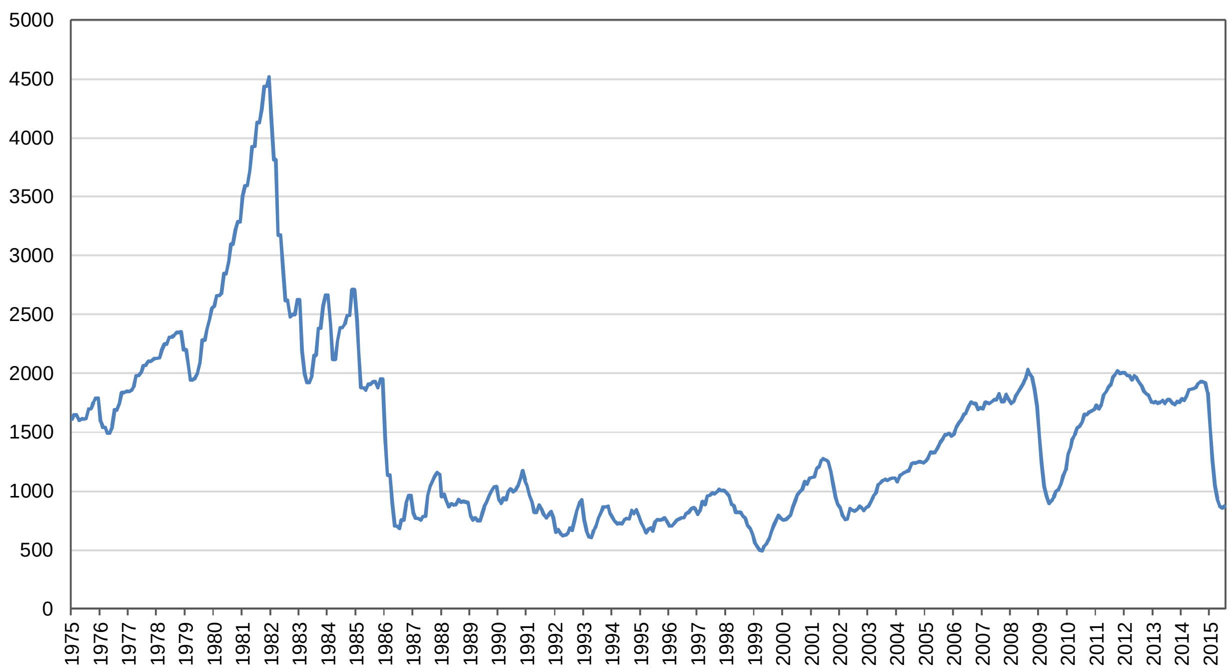
For demand and supply to fall back into balance, we need to see a fall in production. For any fall in supply to be meaningful enough to stabilise prices, it most probably needs to come from OPEC or the US. As it currently stands, OPEC appears focused on increasing, not reducing, their output.

OPEC & Largest OPEC Member Producers Oil Production: 1990 - 2015



Certainly Saudi Arabia, as the largest producer in the OPEC cartel, has recently increased production to record levels. With Iran due to increase production meaningfully over the next year, it seems unlikely as it currently stands that OPEC production will fall. This implies that any meaningful near term rebalance will require a fall in US crude production. This view has been supported by a declining oil rig count in the US. Theory suggests that a declining rig count would lead to a decline in production.

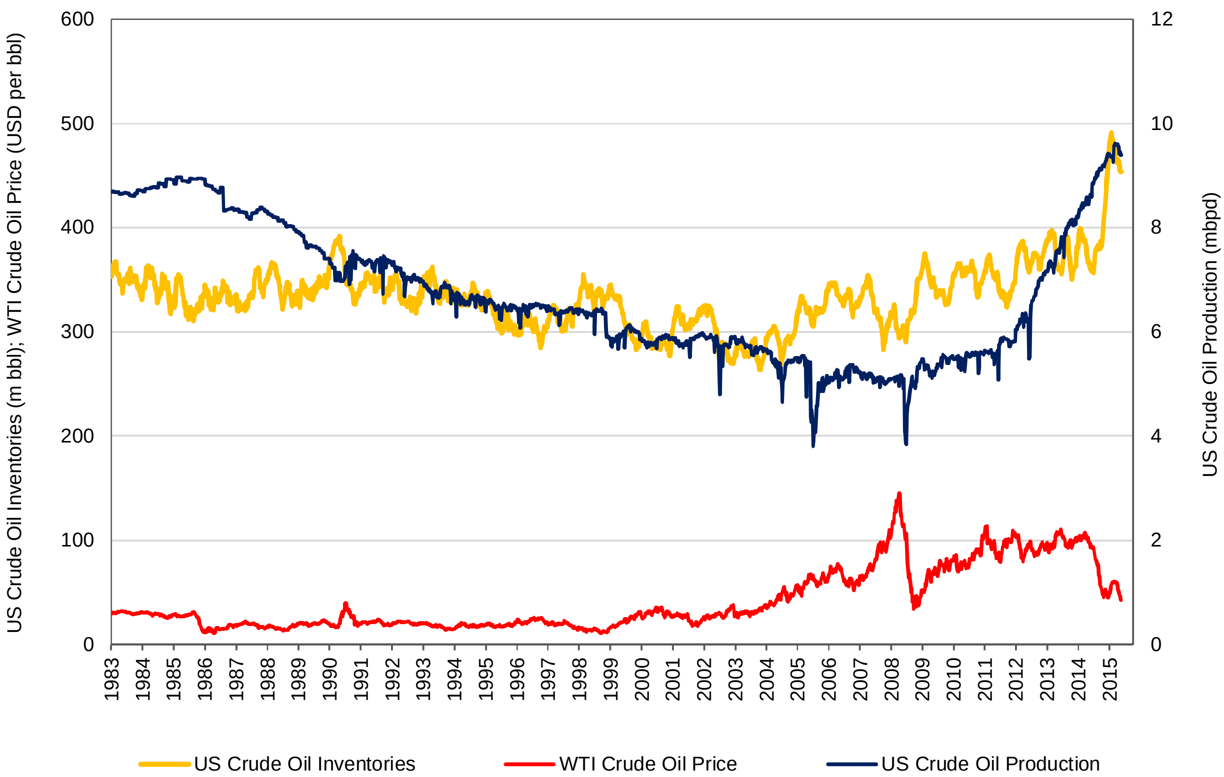
Baker Hughes US Oil & Gas Rig Count



Unfortunately, the rig count has not, to this point, resulted in declining production levels. In fact, crude production has continued to increase significantly despite the fall in the oil price and the fall in the rig count. History suggests that the rig count is not always a reliable indicator of future production levels. In the early 1980's, the rig count reached 4520 at the end of 1981, before dropping below 2000 in May 1983. Despite this, according to the US EIA, annual production in the 1980's peaked in 1985.

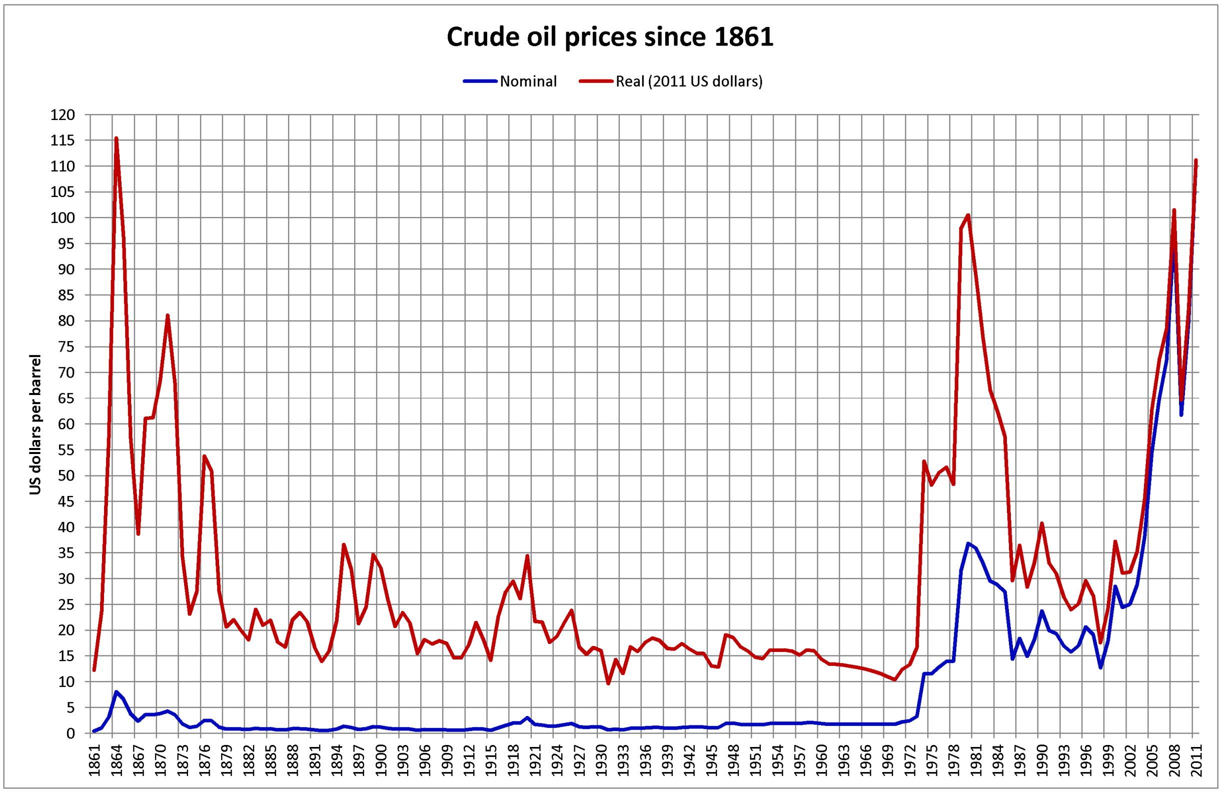
The increase in oil production in the US is not being matched by increasing US consumption. US crude oil inventories have been rising rapidly over recent years, as shown below. The decline in crude inventories over the last few months matches the typical seasonality within the US, where petroleum consumption increases over the northern hemisphere summer period. Despite the fact that summer is drawing to a close, inventory levels are very close to record highs. This has led many commentators to the view that the fall in the oil price has not deterred as much production as might have been anticipated or predicted following the decline in the rig count.

US Oil Production & Inventory Levels



For now the crude oil oversupply looks like it will persist, just as Australia ramps up production from its major new LNG facilities thereby adding to the growing supply of energy into the market. To put this into perspective, in 2013 Australia was the third largest exporter of LNG, producing less than 30mtpa of LNG, or a little less than 10% of global LNG exports. By 2018 Australia is expected to become the largest global producer of LNG with 85mtpa of capacity contributing over 25% of the global export market. The main ramp up is forecast to occur between 2015 and 2017. Of the eight new Australian liquefaction projects that received final investment approval between 2007 and 2012, three have recently begun production while five are still under construction. According to the Reserve Bank of Australia in their March 2015 Bulletin, LNG is anticipated to become Australia's second largest export behind iron ore. The US is also forecast to increase production, with four projects currently under construction with capacity for 50mtpa. This increase in energy supply may well put further pressure on energy prices at a time when emerging market growth appears to have slowed considerably.

In this environment we are cautious about pricing in a meaningful upward move in oil prices in the short to medium term. History suggests that sensible long term price assumptions may well be lower than current spot prices. In fact, analysing 150 years of data suggests that current prices, in inflation adjusted terms, are still above the historical price range. Whether history turns out to be a reasonable guide will be discovered in time.



Oil prices: 1861-1944 averaged US crude oil, 1945-1983 Arabian Light, 1984-2011 Brent
Source: en.wikipedia.org

The danger of group think is obvious often only in hindsight, when reality turns out to be quite different to the unanimous expectation of the market. Anticipation of materially higher oil prices in the near to medium term does not seem supported by the evidence. At Auscap we focus on analysing the facts to draw sensible conclusions about the companies that we are investing in. We find that independent assessment of the facts reduces the risk that our cognitive biases and tendency toward group think will lead us into making erroneous investment decisions.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website 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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