Auscap Long Short Australian Equities Fund Newsletter – November 2015

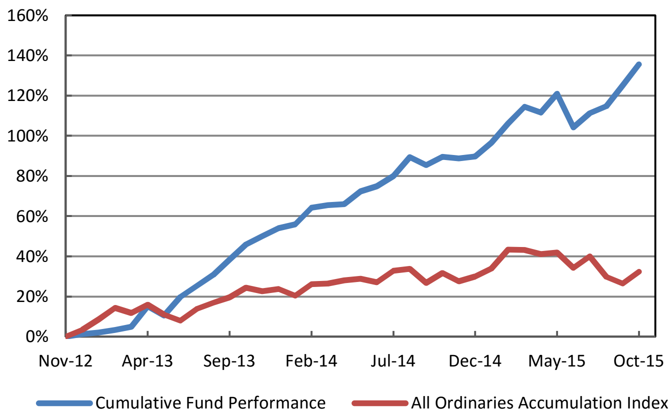
Disclaimer: This newsletter contains performance figures and information in relation to the Auscap Long Short Australian Equities Fund from inception of the Fund. The actual performance for your account will be provided in your monthly statement. Actual performance may differ for investments made in different classes or at different times throughout the year. This newsletter is intended to provide general background information only. It is not a Product Disclosure Statement under the Corporations Act 2001 (Cth), nor does it constitute investment, tax, legal or any other form of advice or recommendation to be relied upon when making an investment or other decision. Past performance is not a reliable indicator of future performance. While all reasonable care has been taken to ensure that the information in this document is complete and correct, no representation or warranty is given as to the accuracy of any of the information provided, including any forecasts. To the maximum extent permitted by law, Auscap Asset Management Limited ACN 158 929 143 AFSL 428014, its related bodies corporate, directors, employees and representatives are not liable and take no responsibility for the accuracy or completeness of this document. No investment in the Fund should be made without fully reviewing the information, the disclosures and the disclaimers contained in the Information Memorandum or any supplement to that document and obtaining investment, legal, tax and accounting advice appropriate to your circumstances.

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 the potential risks around the “comfortable” investments that feature heavily in many Australian domestic equities portfolios.

Fund Performance

The Fund returned 4.65% net of fees during October 2015. This compares with the All Ordinaries Accumulation Index return of 4.59%. Average gross capital employed by the Fund was 102.5% long and 28.3% short. Average net exposure over the month was 74.2%. At the end of the month the Fund had 29 long positions and 6 short positions. The Fund’s biggest stock exposures at month end were spread across the financials, consumer discretionary, consumer staples, healthcare and materials sectors.



Fund Returns

Period	Auscap	All Ords
October 2015	4.65%	4.59%
Financial Year to date	15.35%	(1.47%)
Calendar Year to date	24.21%	1.80%
Since inception	135.54%	32.31%

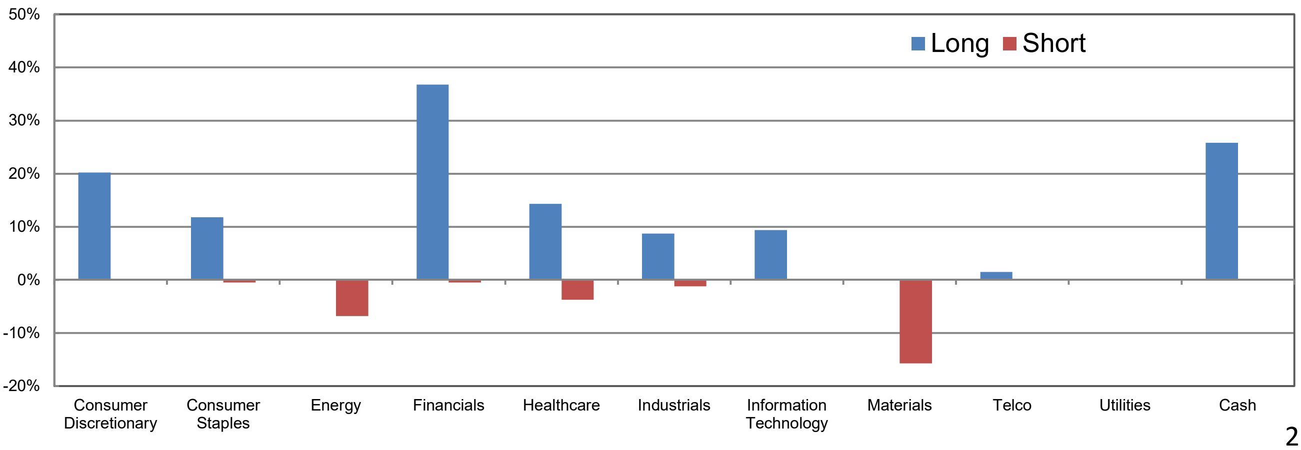
Fund Exposure

October 2015 Average	% NAV	Positions
Gross Long	102.5%	30
Gross Short	28.3%	7
Gross Total	130.8%	37
Net / Beta Adjusted Net	74.2%	36.5%

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	1.64	4.82	4.65									15.35

Sector Exposure - November 2015

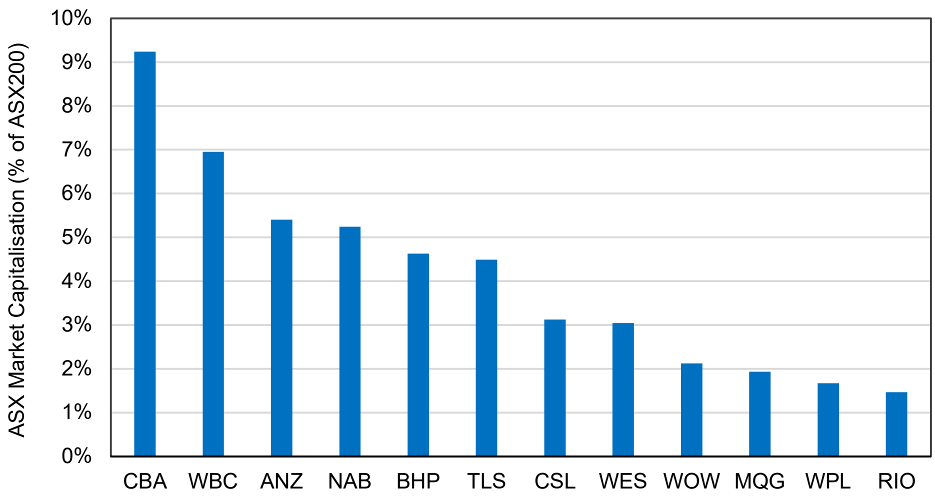


The Dangers of Comfortable Investing

It often *feels* less risky to be in the most widely held stocks. By the very nature of these companies, they are well known, very large and typically well-capitalised businesses. They have been successful in their past endeavours, efficiently executing strategies that have enabled them to become household names. Their size and familiarity offer comfort to the investor. The fact that they are well owned ensures a positive disposition will be held by the majority. This near consensus favourable opinion further encourages the belief that investing in these stocks is both safe and sensible. Somewhere along the way both future earnings and price can become secondary considerations to being invested in these dominant businesses.

Rarely has this been more evident than in the current Australian market. At the date of this report, the largest twelve ASX listed companies make up just under half (49.3%) of the ASX200. These companies are the most widely held in the domestic market, with an average market capitalisation of over AU$58bn and a combined market capitalisation of approximately AUD$705bn. They make up the core part of most superannuation equities portfolios, whether through managed funds or self-managed accounts.

Current 12 Largest ASX200 Stocks



And yet when we analyse the fundamental state of business for these companies, we do not find particularly compelling reasons to invest. To provide a somewhat simplistic summary, acknowledging that such an assessment has limitations:

- The largest banks (and four largest companies in the ASX) are heavily exposed to Australian residential property, property that is expensive on a price to income basis, and trade at multiples of book value not seen in most developed markets. Most importantly these banks are being forced to raise capital through earnings dilutive raisings and restrict certain loan book growth, limiting overall prospective growth.

- The major commodity companies, BHP Billiton, Woodside Petroleum and Rio Tinto, are suffering from falling demand and a continued expansion of supply in the bulk commodities and energy sectors, the combined effect of which is significant and causing commodity prices to continue their adjustment back to the marginal cost of the large suppliers, last seen in the early 2000s. The familiar rhetoric is that it is sensible to own the lowest cost producers in a falling commodity price environment. While these businesses will most certainly continue to operate through the cycle, such commentary ignores the fact that these highly cyclical businesses are cum substantial earnings downgrades over coming periods, during which the ability of mining, oil and gas stocks to pay increasing dividends through time will be seriously tested. The argument that big miners represent “safety” because they operate at the bottom end of the cost curve ignores the fact that they face declining earnings. We have never read an article, quite sensibly we would suggest, that promotes owning a retailer who faces major earnings headwinds, perhaps the result of increased competition both online and foreign (to use a recent example), simply because they are the lowest cost supplier. Yet the lowest cost miner argument seems to be tantamount to as much. (We might add that we have certainly owned a few of these retail stocks that might fall within the “lowest cost & declining earnings” classification and it has not proved a fruitful or particularly enjoyable experience!)

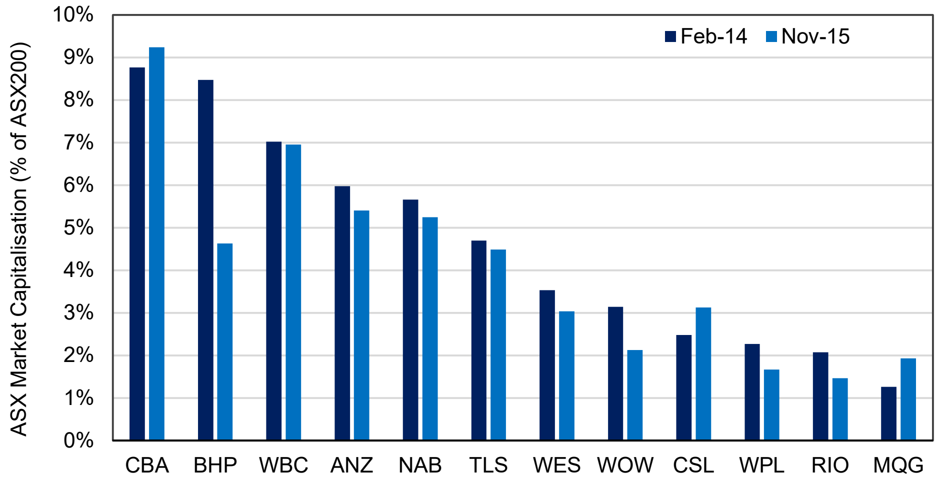
- Telstra, the beneficiary of a historically superior mobile network and a successful negotiation with NBN Co, is facing more difficult competitive pricing pressures and increased investment by its peers.

- The major supermarket players, Wesfarmers and Woolworths, are suffering from increased competition from foreign entrants such as Costco and Aldi, both of which are testing the considerable margins of the aforementioned entities.

While we do not wish to oversimplify the investment merits of these highly successful companies, it is hard not to conclude that a portfolio largely exposed to the most popular stocks in the Australian market is one that faces meaningful earnings headwinds over coming years. Yet despite these headwinds, there would be very few model portfolios that don’t have most, if not all, of the stocks listed above in them. For many there are meaningful legitimate capital gains taxation considerations. However we suspect the fact that investing in these businesses feels comfortable plays more than a minor role. It is unlikely that any investment professional is going to suffer from criticism for suggesting an investment in these companies. But does being comfortable equate to sensible investing? We would define the latter as receiving adequate compensation through prospective return, which we define as current earnings plus anticipated growth in earnings, for the risk one is taking.

It is our view that ultimately earnings drive share prices, underlying the difficulty the broad index faces in progressing in light of the challenges facing the largest Australian companies. To illustrate the point, when the index was at a similar level of between 5050-5100 in February 2014, the same twelve companies listed above had a combined market capitalisation of AUD$745bn and were 55.3% of the index.

Then & Now: Current 12 Largest ASX200 Stocks



In the intervening 20 months many of these large companies have been a significant drag on the index performance, no doubt a function of their aggregate earnings deteriorating during this period. Their combined market capitalisation is now AUD$40bn lower than it was then, and this is despite the fact that all of the banks listed have raised significant capital recently from investors.

Our evaluation above is not an attempt to predict the market's direction. We pay little attention to the index and its constituents. In fact, the more popular the stocks we hold become, the more expensive they typically are and the more cautious we become about our ongoing investment in them. We are of the view that it would be a rare event that a consensus opinion or consensus holding offered substantial prospective rewards for its shareholders. What we would note from our analysis of the index performance however is that there must have been companies that have grown sufficiently to make up for the negative performance that came from this group of leaders. Indeed during this period there have been investment opportunities in companies that have grown sufficiently to offset the decline in the leaders. To some extent an index can be misleading, and the fact that there have been attractive prospective investment opportunities is masked by a flat overall market performance.

We try to evaluate every investment from an objective standpoint. There are, and will continue to be, sensible investment opportunities in the Australian market. We will look to invest in companies that meet our key criteria, which include having good cash generation; a satisfactory historical return on invested capital; a strong balance sheet; an identifiable competitive advantage and management who communicate clearly with shareholders and who act like business owners.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website 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. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.