Auscap Long Short Australian Equities Fund Newsletter – January 2016

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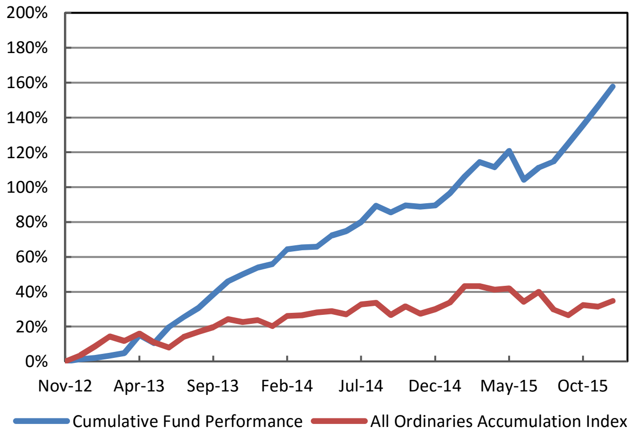
Welcome

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 the current state of the Australian economy and the outlook for 2016.

Fund Performance

The Fund returned 4.56% net of fees during December 2015. This compares with the All Ordinaries Accumulation Index return of 2.65%. Average gross capital employed by the Fund was 100.9% long and 15.4% short. Average net exposure over the month was 85.5%. At the end of the month the Fund had 30 long positions and 7 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
December 2015	4.56%	2.65%
Financial Year to date	26.27%	0.41%
Calendar Year to date	35.96%	3.75%
Since inception	158.82%	34.84%

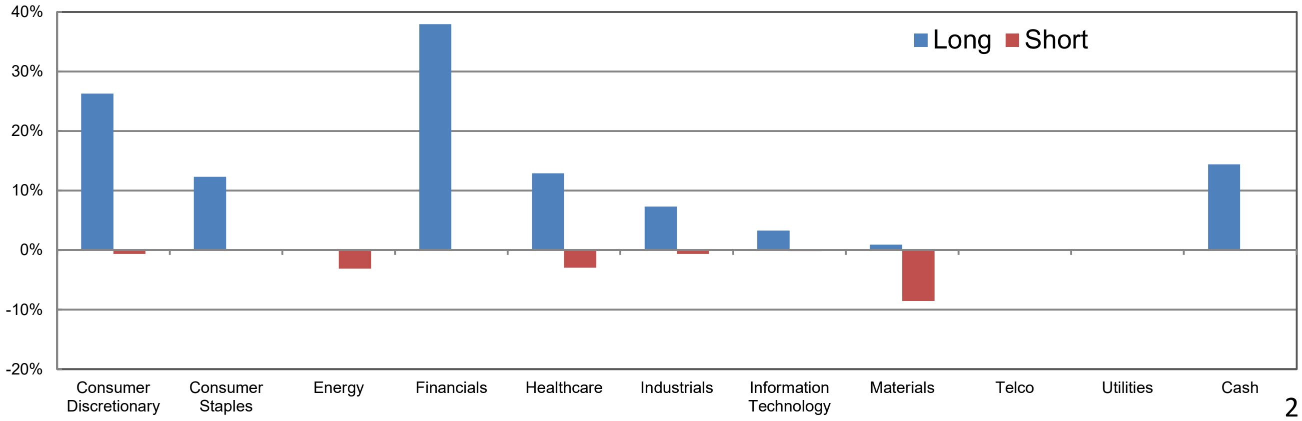
Fund Exposure

December 2015 Average	% NAV	Positions
Gross Long	100.9%	29
Gross Short	15.4%	8
Gross Total	116.3%	37
Net / Beta Adjusted Net	85.5%	50.7%

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	4.69	4.56							26.27

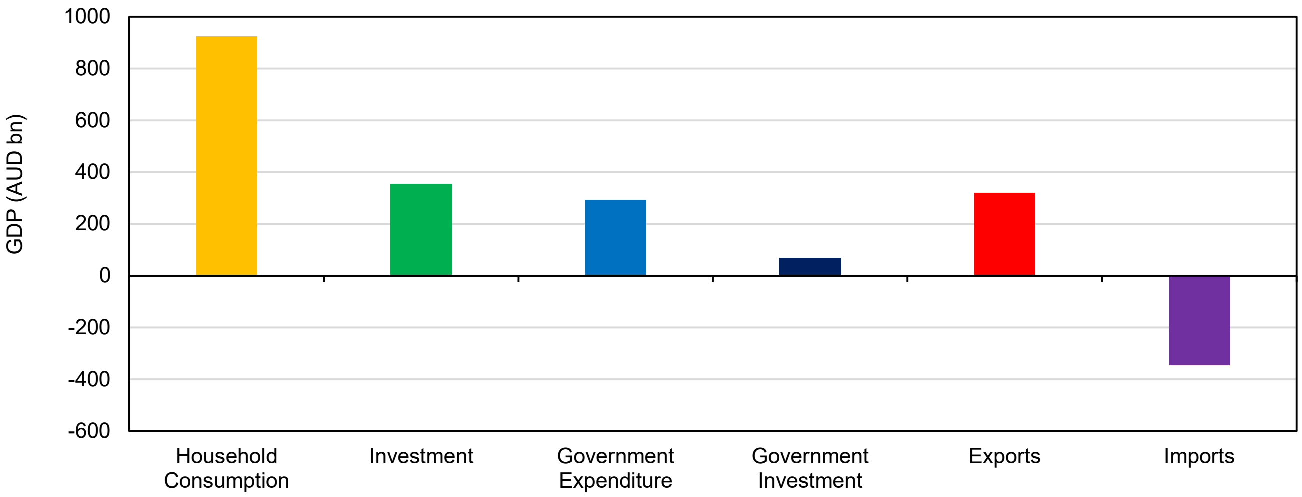
Sector Exposure - December 2015



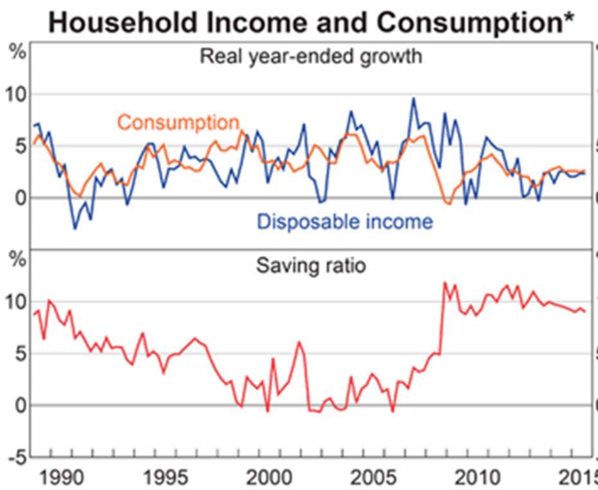
The Good, the Bad and the Ugly of Australia's Economic Growth

It would appear that 2016 has commenced with the ugly. At the time of publication, the calendar year is 12 business days in and the All Ordinaries Index is down 7.2%. Unfortunately a quick analysis of the state of the Australian economy suggests that, perhaps like the stockmarket, the year ahead holds plenty of challenges. At first glance it certainly appears that the Australian economy, the key components of which are discussed below, faces a number of near term headwinds. While these challenges are likely to limit growth, we hope that they will offer us a number of opportunities to do what we always attempt to do, buy good companies at attractive prices.

Australian Gross Domestic Product by Segment
(Year ending 30 Sep 2015)



Household consumption is the biggest component of Australian economic activity, accounting for approximately 57% of the nation's gross domestic product (GDP). Consumer spending typically follows income growth, which has been positive albeit slow in recent years. While lower oil prices, if they translate into lower petrol prices, should temporarily boost expenditure, it is hard to envisage a catalyst for a meaningful and sustained pickup in household consumption given the headwinds facing the rest of the economy (outlined below). That said, consumer expenditure has and should continue to contribute positively to economic growth.



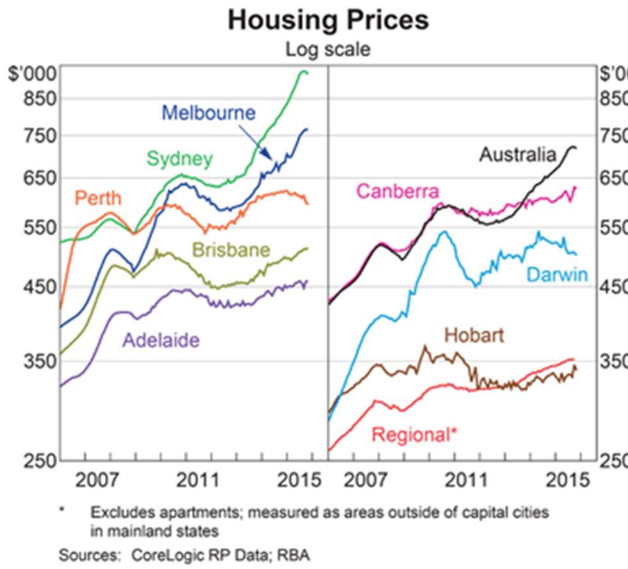
* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

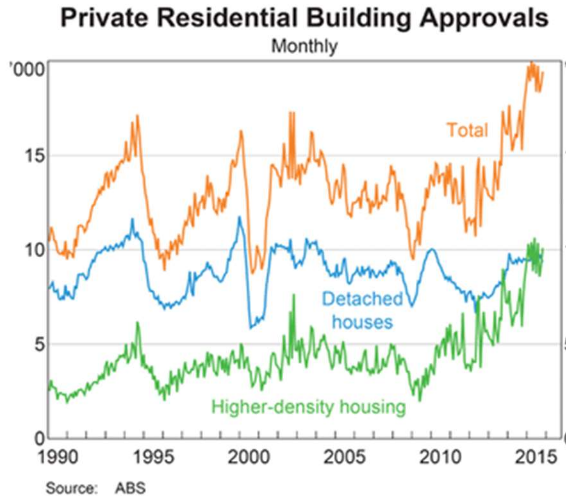
Sources: ABS; RBA

* Percentage change over year to latest three months

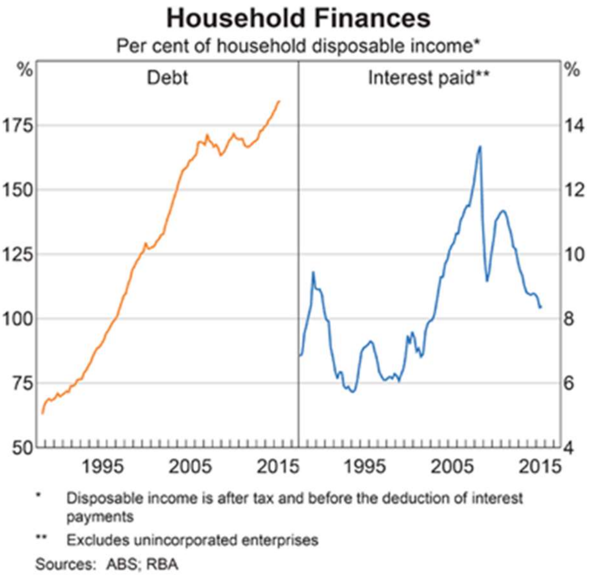
Source: ABS

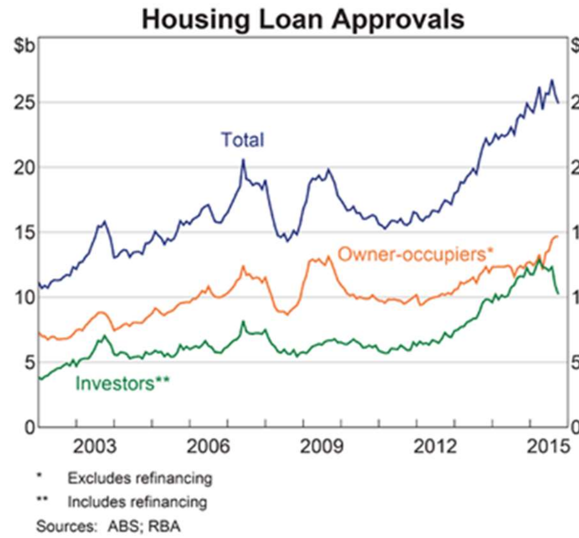
Private investment falls under two main categories, housing construction with any associated transfer costs and business investment. Evidently the domestic housing market has been performing strongly on the back of rising house prices, which have driven an increase in residential building approvals and consequent building construction, a significant stimulant to growth in recent years. However, the close correlation between rising house prices, increases in building approvals and the accumulation of household debt warrants analysis.



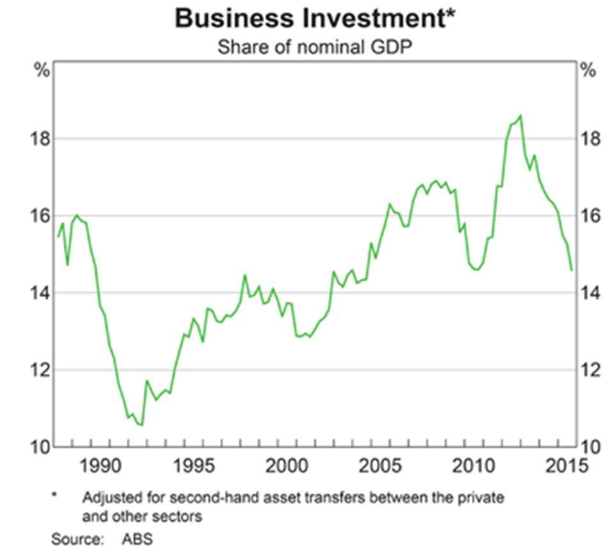


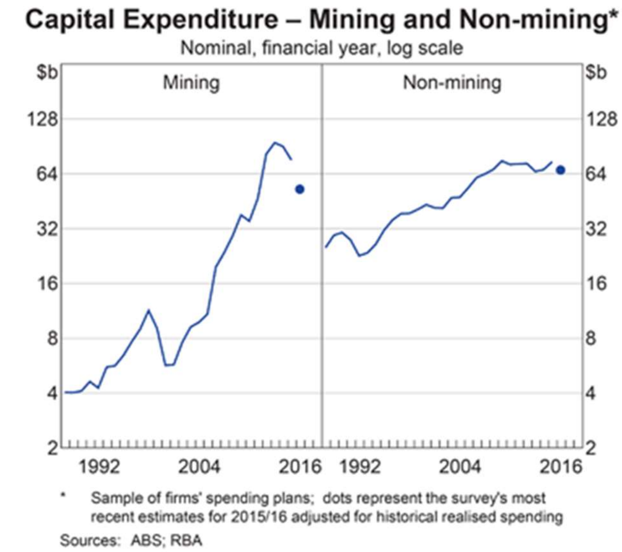
Rising household debt as a percentage of disposable income cannot continue indefinitely. The recent fall in investor home loan approvals, in part due to a tightening of lending standards in the banking sector, suggests the potential for a softening in house prices. As Australia starts to cycle the strong recent housing construction cycle, housing will likely contribute less to economic growth in the near term than it has in the immediate past.



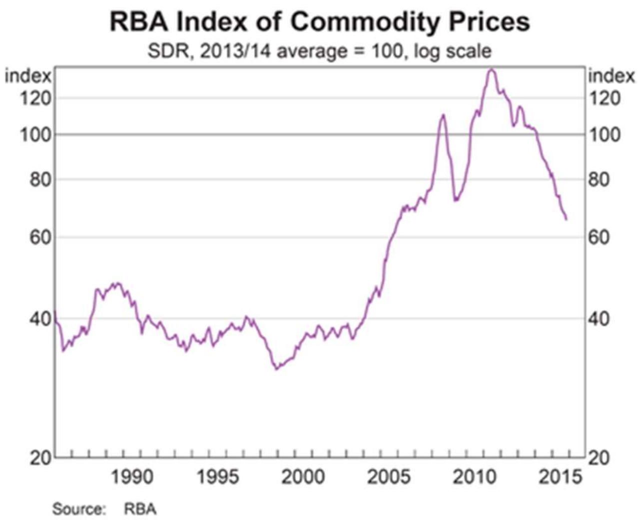


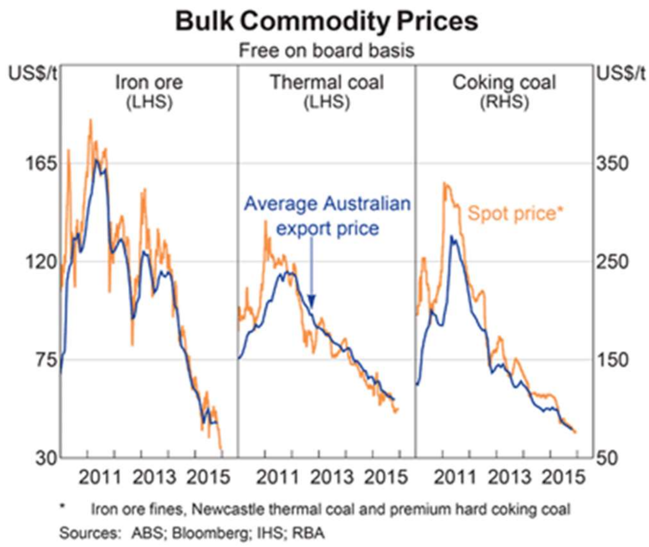
Business investment has been a major driver of economic growth over the last decade. However the investment cycle, particularly in relation to the mining and energy sectors, has largely run its course. Business investment will continue its decline with the completion of many large long-lead projects. As the RBA forecasts imply, a softening in both mining and non-mining capital expenditure will detract from overall economic growth.



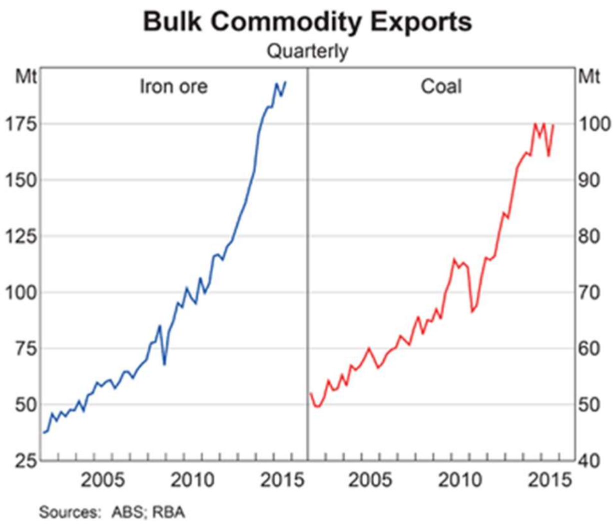


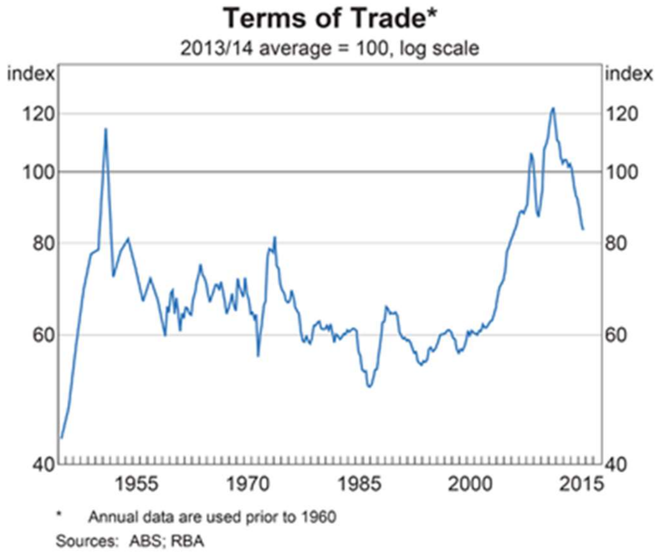
In relation to Australian exports, commodity demand has grown to unprecedented levels as a result of China's fast-paced economic development. Demand exceeded supply for many years, creating windfall profits for domestic mining companies, the Government and the economy. As production increased to cater for the additional demand, prices have gradually tracked lower as the market moves back into long term equilibrium. Falling prices have offset some of the benefit from increasing export volumes. However, prices still appear to be above long term trend levels.



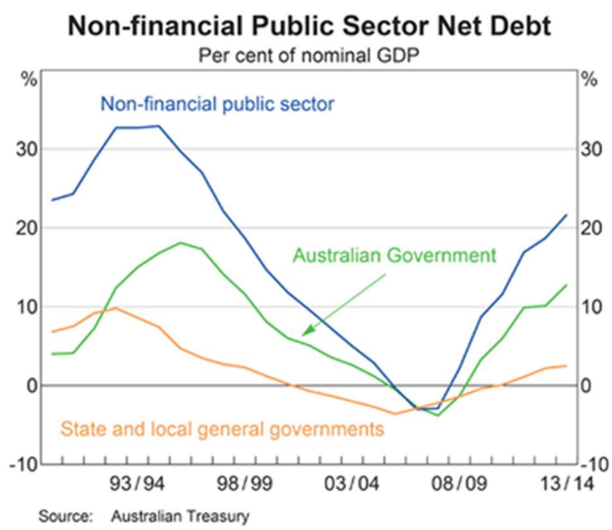


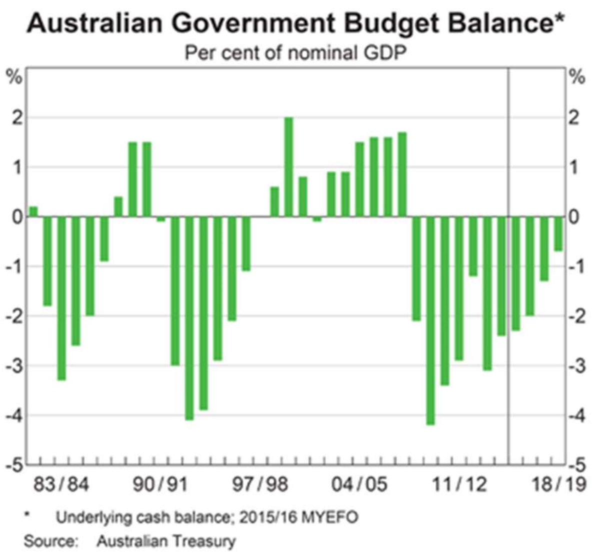
Falling prices have resulted from increasing production, not declining demand. As seen below, exports of bulk commodities are at record levels. Whether this can continue is a question of debate. We would take note of the comments made by Li Xinchuang, President of the China Metallurgical Industry Planning Association, in July 2015 when he suggested to the *Australian Financial Review* that Chinese steel production had peaked and was likely to fall by 23% by 2030. Should demand for steel, and hence Australian iron ore and coal, fall in China, the corresponding decline in export volumes would cause an acceleration in the decline of Australia's terms of trade. Any such decline would act as a material and reasonably ugly drag on economic growth.

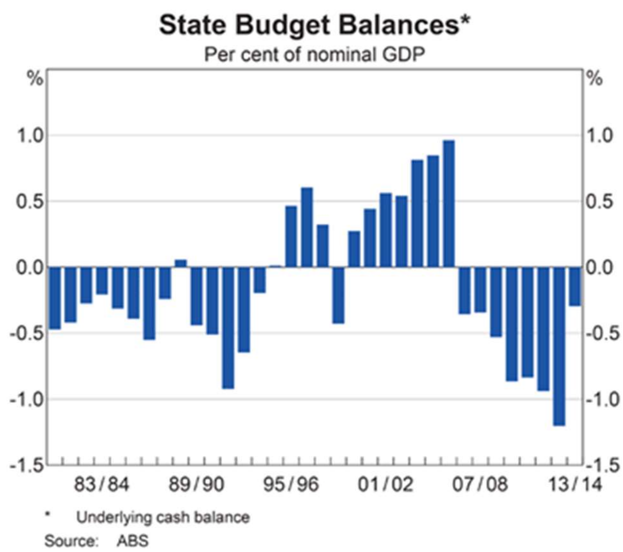




Finally, Government expenditure is dependent on both Government receipts and a willingness to incur deficits. Recently the buoyant property market has boosted Government coffers through the collection of property related taxes. This is particularly evident in the recovery of state finances. The commodity supercycle has also continued to positively affect government revenues. Commodity export volumes are at record levels. Any revenue declines in the mining and energy sectors will impact government collections, rendering it more difficult for the Federal and State Governments to increase their spending in the face of widening budget deficits. Should economic headwinds prevail for the foreseeable future, it is unclear whether the state and federal Governments would be willing to allow further increases in the deficits they are currently forecasting.







As many of the key components of Australia's GDP are facing difficult circumstances in the near term, strong economic growth may prove somewhat elusive. This contrasts with analyst expectations for corporate earnings growth in 2016 which, based on Bloomberg forecasts, appear to be in excess of 12%. This disconnect between the top down analysis and the bottom up earnings forecasts provides some cause for concern. While we generally adopt a cautious approach to investing, we are particularly cautious when aggressive assumptions are the major factor supporting valuation. At Auscap we will continue to look for investment opportunities in stable, cash producing businesses that generate acceptable returns on capital when they occasionally trade at attractive prices. While we are cautious about the economic growth outlook for the year ahead we are optimistic that it may provide us with such opportunities.

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