Auscap Long Short Australian Equities Fund Newsletter – July 2016

The Auscap Fund has been given a rating of Recommended by Zenith Investment Partners.
Interested sophisticated or wholesale investors are encouraged to download Zenith's review of the Auscap Fund available at www.auscapam.com/zenithreport/

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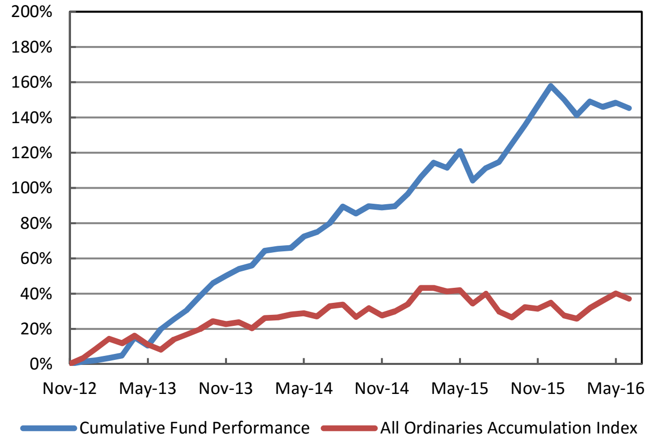
Welcome

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 distinction between conventional and conservative investments.

Fund Performance

The Fund returned negative 1.19% net of fees during June 2016. This compares with the All Ordinaries Accumulation Index return of negative 2.28%. Average gross capital employed by the Fund was 76.6% long and 15.0% short. Average net exposure over the month was 61.6%. At the end of the month the Fund had 30 long positions and 8 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, consumer staples, materials and energy sectors.



Fund Returns

Period	Auscap	All Ords
June 2016	[1.19%]	[2.28%]
Financial Year to date	20.13%	1.98%
Calendar Year to date	[4.86%]	1.56%
Since inception	145.29%	36.94%

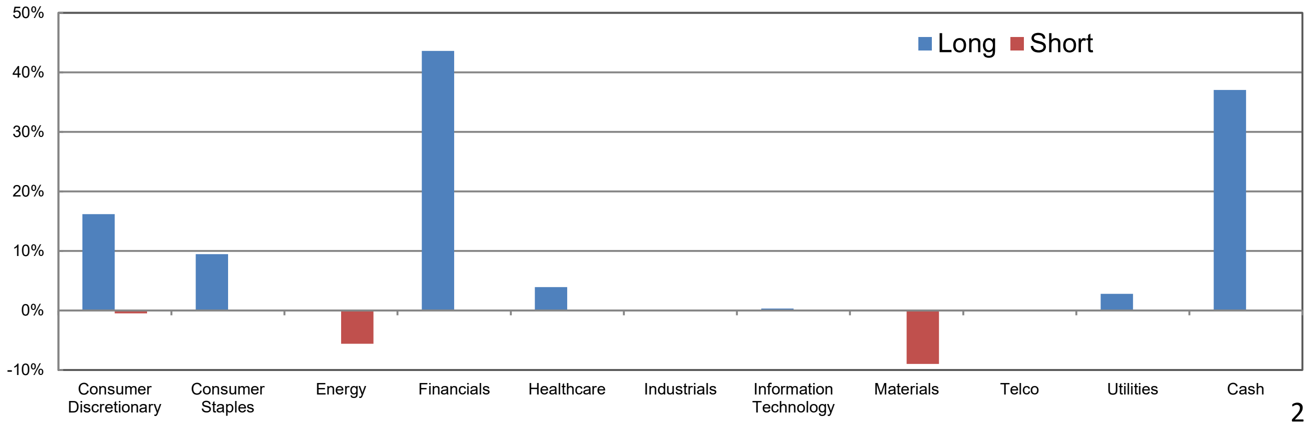
Fund Exposure

June 2016 Average	% NAV	Positions
Gross Long	76.6%	27
Gross Short	15.0%	8
Gross Total	91.6%	35
Net / Beta Adjusted Net	61.6%	36.0%

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	(3.01)	(3.54)	3.22	(1.24)	0.96	(1.19)	20.13

Sector Exposure - June 2016



Acting Conservatively vs Acting Conventionally – Is There A Difference?

The Fund had a good financial year in 2015-16, finishing up 20.13% net of fees. This compares favourably with the All Ordinaries Accumulation Index which returned 1.98% and had a closely fought battle with the RBA cash rate return of 2.04%. It was a year in which the average investor, despite typically being invested quite conventionally, did quite poorly.

The All Ordinaries Accumulation Index masked the significantly worse performance of the top 20 stocks in the market. The ASX20 Accumulation Index returned *negative 7.0%* for the year (including dividends). This is noteworthy because of the market capitalisation dominance of those top 20 companies, which at the time of writing constituted over 51% of the All Ordinaries Index by market capitalisation. They are names that are very familiar to most investors and dominate most retail investors' portfolios. Many of the individual stocks did significantly worse than the index, with their financial year performance figures listed below.

Company	FY16 Performance	Company	FY16 Performance
AMP	– 9.8%	Rio Tinto	– 9.8%
Australia and New Zealand Banking Group	– 19.8%	Scentre Group	+ 38.0%
BHP Billiton	– 27.7%	Suncorp Group	– 3.5%
Brambles	+ 19.9%	Transurban Group	+ 34.7%
Commonwealth Bank	– 7.2%	Telstra	– 4.2%
CSL	+ 32.1%	Westpac Banking Corporation	– 2.2%
Insurance Australia Group	+ 5.4%	Wesfarmers	+ 8.1%
Macquarie Group	– 10.8%	Westfield Corporation	+ 21.0%
National Australia Bank	– 15.4%	Woolworths	– 18.7%
QBE Insurance Group	– 20.4%	Woodside Petroleum	– 17.5%

These investments are the most conventional of stock holdings. It begs the question, just because someone is invested conventionally, does that mean that they are invested conservatively? Most investors who hold large positions in these companies believe that because these businesses are household names, they must also be the *least risky* stocks to hold. But the connection between company size or familiarity and risk is a tenuous one. The most important determinant of investment risk is the price paid for the investment. A poor asset purchased well under liquidation value can still be a great investment, just as a great asset bought at too high a price can prove a lousy one.

> *"Unfortunately, often there is so much confusion between acting conservatively and acting conventionally that for those truly determined to conserve their assets, this whole subject needs considerable untangling".*
>
> Philip Fisher, *Common Stocks and Uncommon Profits*

In his book *Common Stocks and Uncommon Profits*, first published in 1958, famed investor Philip Fisher highlighted what he believed to be the four important characteristics of conservative assets:

1. Superior operating performance, defined as being a "very low cost producer or operator in its field, [with] outstanding marketing and financial ability and a demonstrated above-average skill on the complex managerial problem of attaining worthwhile results from its research or technological organisation".

2. Outstanding, high quality people, employees who are responsive to change and enjoy their workplace, and management who are disciplined in building the long range profits of the business (and not solely focused on short term results).

3. Inherent characteristics of the business that demonstrate above-average profitability, "what can the particular company do that others would not be able to do about as well?", typically demonstrated by the company's superior return on invested assets and/or profit margin on sales.

4. The price paid for the investment.

We find that the fourth characteristic is often the most significant factor when determining the expected return of an investment. Our approach is focused on finding investments that are priced so that we have both an attractive total return expectation and a sufficient margin of safety for the investment should business conditions or company circumstances prove to be worse than our initial expectation.

Most of the businesses we are attracted to are widely known to be very good businesses. They have the following characteristics that are commonly sought after (as highlighted by the similarity between this list and Philip Fisher's four dimensions):

- a simple business model selling products and/or services that we are familiar with;
- a sustainable competitive advantage;
- an attractive return on invested capital;
- significant cash flow generation;
- a strong balance sheet; and
- competent, disciplined management.

Many of the large Australian businesses listed above we would characterise as good businesses. But a good business bought at too high a price will still generally make a poor investment, especially from a risk-adjusted return perspective. Our view a year ago was that many of these businesses were priced well above our estimate of fair value. They may have appeared to be conservative investments, but in reality they were more conventional investments, and somewhat expensive conventional investments at that.

We are reminded of the Warren Buffett adage, "price is what you pay, value is what you get". At Auscap we try to ensure that we get more value than we pay for when purchasing securities. If we can do so over time our investors should earn an adequate return on their capital.

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.

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