Auscap Long Short Australian Equities Fund Newsletter – November 2016

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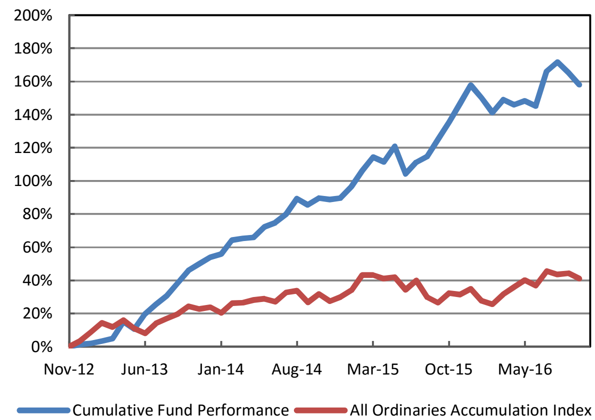
Welcome

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 analyse some of the investment risks that we consider most carefully before purchasing shares.

Fund Performance

The Fund returned negative 2.72% net of fees during October 2016. This compares with the All Ordinaries Accumulation Index return of negative 2.18%. Average gross capital employed by the Fund was 123.2% long and 10.1% short. Average net exposure over the month was 113.1%. At the end of the month the Fund had 35 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the financials, real estate, consumer discretionary and telecommunications sectors.



Fund Returns

Period	Auscap	All Ords
October 2016	[2.72%]	[2.18%]
Financial Year to date	5.21%	3.03%
Calendar Year to date	0.10%	4.64%
Since inception	158.07%	41.09%

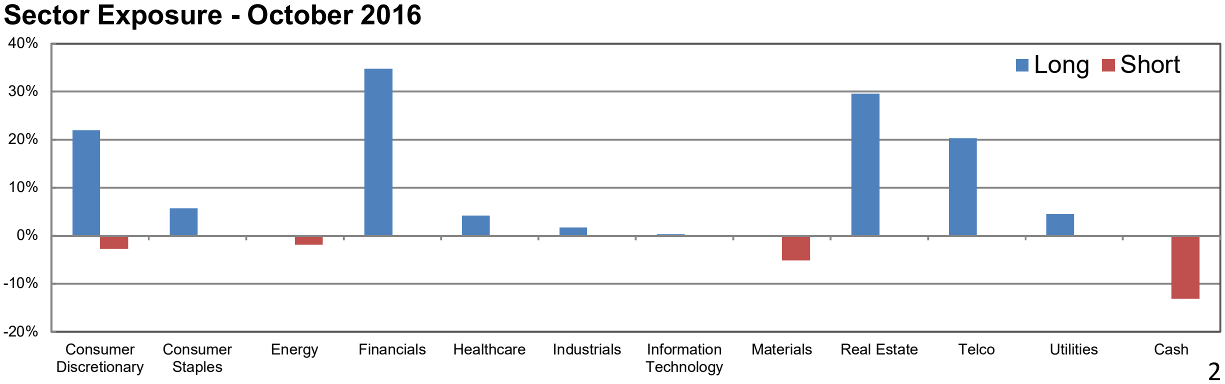
Fund Exposure

October 2016 Average	% NAV	Positions
Gross Long	123.2%	32
Gross Short	10.1%	7
Gross Total	133.3%	39
Net / Beta Adjusted Net	113.1%	74.4%

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
FY17	8.48	2.13	(2.37)	(2.72)									5.21

Sector Exposure - October 2016



Part 2: Recognising investment risks

Investment risk is the probability or likelihood of loss in relation to a particular investment. In the last newsletter we discussed business risks as some of the most apparent investment risks when purchasing shares of a listed company. But there are plenty of investment risks that are not business risks. In this newsletter we discuss our approach to some of the investment risks that we consider important in analysing opportunities.

Awareness risk is most easily linked with the business risks discussed in the last newsletter. Awareness risk arises when a lack of understanding or consideration of the actual business risks associated with the company results in an underappreciation of the risks involved with an investment. Very few investors have the time or the inclination to assess a new company or industry in sufficient detail to be in a position to properly understand, synthesise and accurately assess the most relevant business risks. To minimise awareness risk we focus on industries and companies where we are inherently familiar with the products and/or services they provide. These are businesses where we do not need significant specialised knowledge to understand most aspects of the business's operation. In this way we reduce the risks that are unknown to us due to a lack of knowledge or experience. We try to remain consistently cognisant of these risks so that we objectively analyse each investment opportunity.

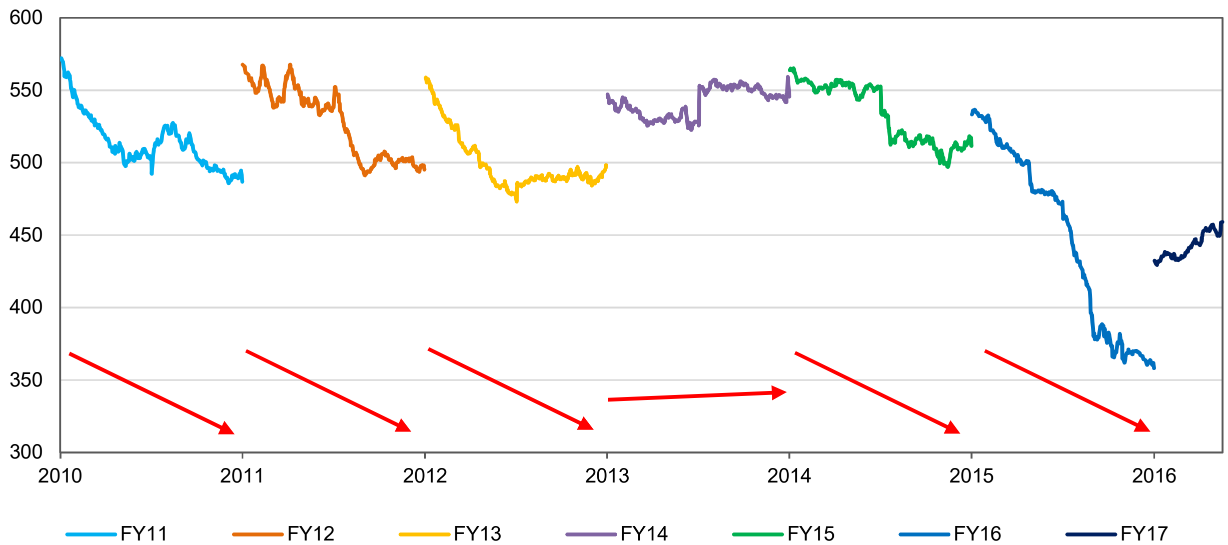
Valuation risk is probably the most discussed investment hazard that isn't a business risk. It is the risk that an investor pays too high a price for a given asset and risks capital loss, potentially even in situations where business performance is in line with expectations. Valuation risk is most common when very few business risks are apparent to the broader market and are therefore not being appropriately priced. Typically, when a risk is most visible it is being priced accordingly and investors are well compensated for accepting the particular risk. When risk is least visible it is often underpriced, leading to an investment carrying the most inherent pricing risk.

One absurdity of markets is that sometimes the same risk can be priced very differently *without any change in circumstances* just because the visibility of the risk has increased or decreased. It may simply be a change in the mood of the majority in the market. More likely it is because of an adjacent event that makes investors consider a risk more carefully and adjust their valuation parameters accordingly. The opposite also seems to hold for risks that have not presented themselves for a considerable period of time. As Warren Buffett wrote in an article in *Forbes* magazine in September 2008, "*you pay a very high price in the stock market for a cheery consensus*". Valuation risk is most evident when circumstances for a business are favourable and investors, excited by the company's prospects, price the business for continuing prosperity.

Valuation risk is often a function of **forecasting risk**. Investors extrapolate historical growth rates into perpetuity, ignoring the risk that their assumptions are positively or negatively biased. Most industries are cyclical, yet the market frequently prices securities for ongoing growth when times are good and for very little growth when times are tough. This offers investors a form of "time arbitrage" that we look to take advantage of through buying companies based on a medium term view of the outlook for the company, as opposed to focusing on the short term headwinds the market is assuming will continue into the future when pricing the security. Similarly, we seek to avoid companies trading at prices that assume favourable conditions will continue indefinitely.

Generally the market is more positively biased than negatively biased, leading to forecasting assumptions that are, by and large, too optimistic. The chart below demonstrates that investment analysts are generally too bullish on the outlook for company earnings, leading to a gradual lowering of earnings expectations over the course of a given year. Since 2010, initial analyst expectations for the Earnings Before Interest and Tax (EBIT) of the ASX200 have proved optimistic and seen downward revisions over the course of the fiscal year in every period except for Financial Year 2014. As value investors we prefer to scour the market for companies where expectations are quite low, leading to potentially attractive prices and the prospect of a reasonable total return over time from a given investment.

ASX200 *Forecast* Earnings Before Interest & Tax (EBIT)



Investors also face **liquidity risk** where, despite the shares of a company being publicly traded, there is insufficient liquidity in the company's shares to be able to sell when an investor wishes to sell, unless he or she is willing to compromise significantly on price. Sometimes illiquidity means that an investor cannot exit at *any* price. The liquidity risk is usually the result of **event risk**. This is when an event occurs and suddenly a risk that the majority of investors were unaware of, or thought had a very low probability of occurring, becomes reality and significantly affects the valuation of the business affected.

We never knowingly accept the risk around a binary outcome. We will not invest in a company which has a single unproven product that may or may not be a success. Any chance of an investment being worth a fraction of its current value tomorrow based on a known risk is, from our perspective, unacceptable. Most investors, ourselves included, will learn this the hard way.

We also look to avoid situations where the risks appear to be asymmetrically skewed against us. We are not a heavy participant in new issues for this reason. It is very difficult for us to get past what appears to be an obvious risk. If an informed seller is happy with the valuation that the investment market is willing to pay for his or her company, should we not be unhappy with that price? In a few situations we are able to logically answer this question in the negative, but not often.

This is not a comprehensive list of investment risks, but it sets out some of the factors we think about carefully when making investment decisions. Consideration of these factors leads to strict investment parameters and a valuation methodology that attempts to limit the significance of such risks in our portfolio. Awareness risk leads to a focus on businesses we are inherently familiar with. Valuation risk leads us towards companies that are priced attractively. Forecasting risk ensures we focus on companies where the majority are cautious on the outlook and have conservative forecasts in their models. Liquidity risk leads us, ceteris paribus, toward preferring investments in larger and more established companies. Event risk leads us to avoiding known binary outcome situations that are material to valuation. Indeed our approach to risk *defines* our investment process.

As investment managers, our role is to assess and manage risk for our investors. Our role is not to minimise risk, but to minimise risk for a prospective level of return. As managers, we want to reduce or eliminate unnecessary risks to investor capital. As long term investors, we prefer situations where we know the level and types of risk are generally assessable. If we are going to accept risk, and that is our task, we are only happy to accept it when we believe we are appropriately compensated through the price we pay.

It is worth noting that an investment manager’s results don’t necessarily reflect the risk taken over the short term. They may simply reflect variance and luck. The amount of investment risk an investment manager takes to deliver certain returns is almost impossible to accurately quantify. Historical data might, if measured over a sufficient period of time, give some indication as to the risk taken to generate certain returns, but will not provide a definitive conclusion. Results are not only a function of the risk taken. To use a simple example, someone who has been extremely lucky on a disproportionately large and risky investment may appear to have great returns with potentially low volatility (the common historical measure of risk), and yet to draw a conclusion that this was a low risk investment approach would be incorrect.

Volatility is the most common measure of risk, but it does not always accurately measure risk over the short term. It may reflect the mood of the market, or be biased toward a particular investing approach, or subject to unusual circumstances surrounding an investor’s portfolio. Analysing a manager’s returns over a sufficient time period in the context of the volatility of the returns, while far from a perfect measure, is probably the best known, calculable way for investors to assess investment managers. The Sharpe and Sortino ratios are both standardised measures for assessing return against risk. We would couple this analysis with an interpretation of the manager’s understanding of risk through the investment manager / client discourse. From this perspective we will continue to provide our investors with insights into our thinking as investment managers with the aim of attracting long-term like-minded unitholders.

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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