Auscap Long Short Australian Equities Fund Newsletter – May 2016

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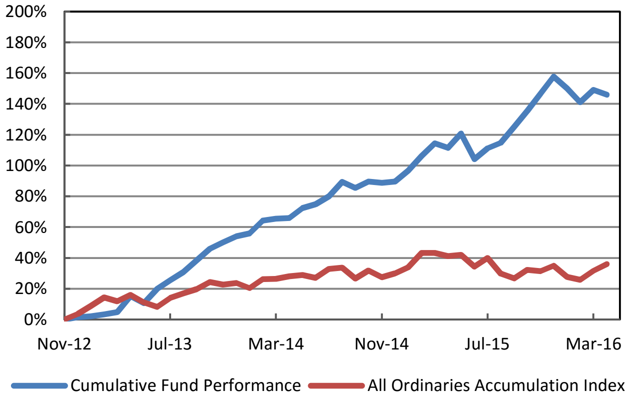
Welcome

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 investment opportunity set in the context of the Fund's lower gross exposure to the market.

Fund Performance

The Fund returned negative 1.24% net of fees during April 2016. This compares with the All Ordinaries Accumulation Index return of 3.24%. Average gross capital employed by the Fund was 51.3% long and 12.7% short. Average net exposure over the month was 38.6%. At the end of the month the Fund had 20 long positions and 5 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, consumer staples, healthcare and energy sectors.



Fund Returns

Period	Auscap	All Ords
April 2016	[1.24%]	3.24%
Financial Year to date	20.42%	1.23%
Calendar Year to date	[4.63%]	0.81%
Since inception	145.89%	35.93%

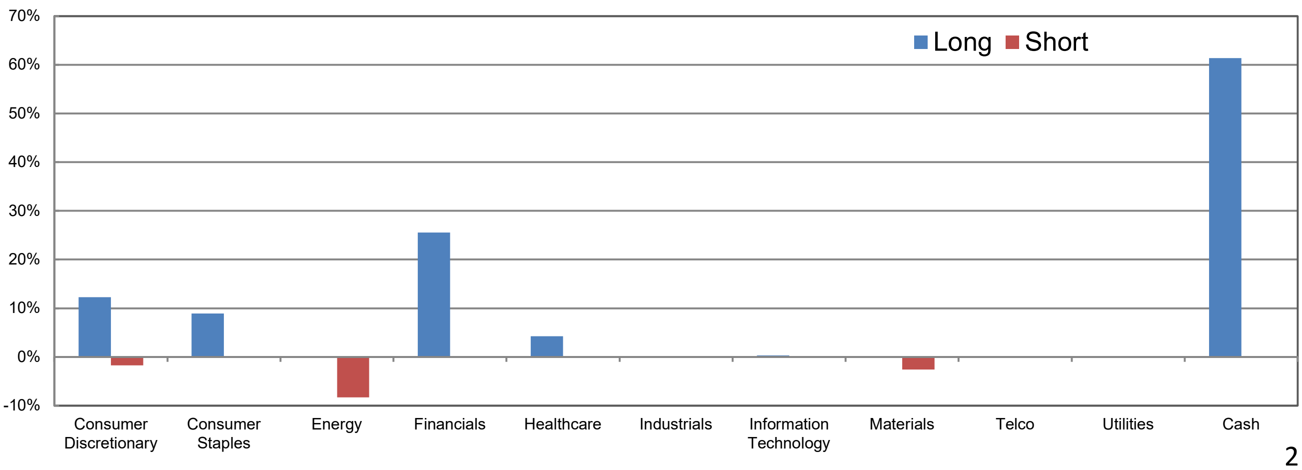
Fund Exposure

April 2016 Average	% NAV	Positions
Gross Long	51.3%	18
Gross Short	12.7%	5
Gross Total	64.0%	23
Net / Beta Adjusted Net	38.6%	18.5%

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	4.69	4.56	(3.01)	(3.54)	3.22	(1.24)			20.42

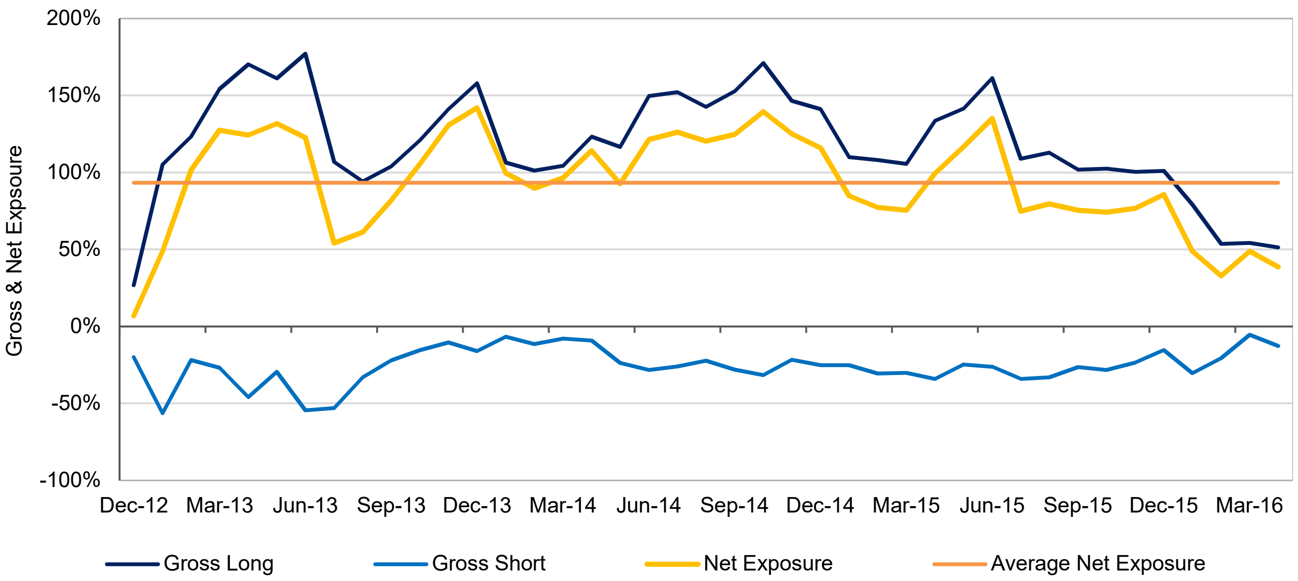
Sector Exposure - April 2016



When less is more: investing with patience and conviction

Attentive readers will have noticed in recent months the increasing level of cash being held in the Fund. In fact, cash levels have recently been close to levels not seen since the Fund's inception. This is a function of a reduction in both the gross long investments and gross short positions held by the Fund. This has not been a result of us, as managers of the Fund, taking a view on the direction of the market. Unfortunately we do not have any such predictive powers. That we had reduced our long exposure prior to a significant market correction in January was merely a coincidence.

Auscap Fund Gross & Net Exposures since inception



So why have we been reducing our gross exposure? Almost all of the decisions we make as managers are stock specific. (We say almost because we do consider overall sector exposure to remain cognisant of sector concentration and exposure to individual unpredictable risks that might affect one particular sector heavily.) We do not try to forecast the market's direction. As John Kenneth Galbraith famously remarked, and we tend to agree, "*there are two types of forecasters, those who don't know and those who don't know they don't know*." Rather, our exposure is a function of the opportunity set available to us. We assess each opportunity on its merits. Are we being offered an attractive absolute prospective return for the risk we are taking in investing in the company being analysed? If we are seeing a lot of compelling long absolute return opportunities, our net exposure is higher. If we are seeing a lot of compelling short positions, our net exposure will be lower. And if we are seeing fewer sufficiently attractive opportunities our gross and net exposure will be lower.

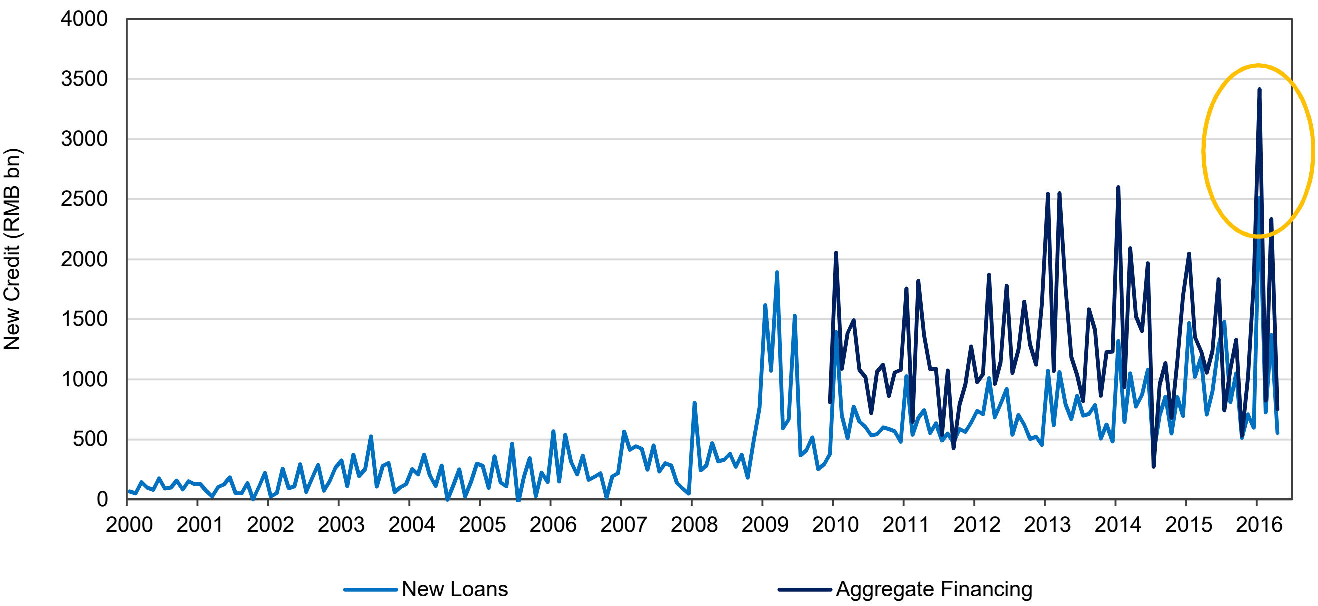
Typically we start to sell a long investment for one of two reasons. We may realise that we are incorrect in our investment thesis. This can occur for a number of reasons. New information might come to our attention that we were not previously aware of. The facts around the investment might change. Our perception of the importance of different factors affecting the business might change. Whatever the reason, if we believe that our investment thesis is no longer valid, we exit the investment. The second reason we sell a security is if it trades to a level that we consider to be above our estimate of fair value. Our estimate of fair value is typically not a particular price but a range of prices. This range will move over time as business earnings and cash flow grow. We prefer all of our securities to be priced somewhere between attractively priced and fair value. We can handle modest overpricing, especially if the tax consequences from selling are meaningful, but if a stock trades to a level well above what we consider to be reasonable, we reduce and often exit the position entirely. This is not our preference, but if the total return offered by a security at a particular price is unattractive, we would rather look to invest the Fund's capital elsewhere, or wait in cash until such an opportunity arises.

In the last quarter of calendar year 2015, a number of our long held investments rose to levels that were above our estimate of fair value, and hence we started reducing these positions. In particular, our exposure to the telecommunications, financials, industrials and healthcare sectors decreased considerably. We have not immediately seen attractive alternative uses for this capital, so our cash holdings have increased.

Our short positions have also reduced in quantum and gross exposure since the start of the year, although a little more slowly initially. If we had any sort of ability to predict market direction, reducing our short positions before the commencement of the enormous rally in resources would have been very helpful. The short positions had fallen considerably, and we probably should have taken action to reduce the exposures as their relative attraction declined, but given the direction of the economic data in China during the second half of 2015 we decided not to cover. As stated, if anyone had any predictive power as to what was going to happen next it would have been particularly helpful in January and early February!

So what caused the commodity rally and why did we reduce our short exposure? In January the Chinese Government pumped enormous liquidity into their market. Aggregate financing increased by 3.425 trillion renminbi (A$720bn) in January alone. New loans were over 2.5 trillion renminbi (A$530bn). This was 71% and 67% higher respectively than new credit issued in January 2015. Despite the moderation in February, new lending still grew by over 25% year on year in the first quarter, and new aggregate financing increased 42%.

New Credit in China surged in early 2016

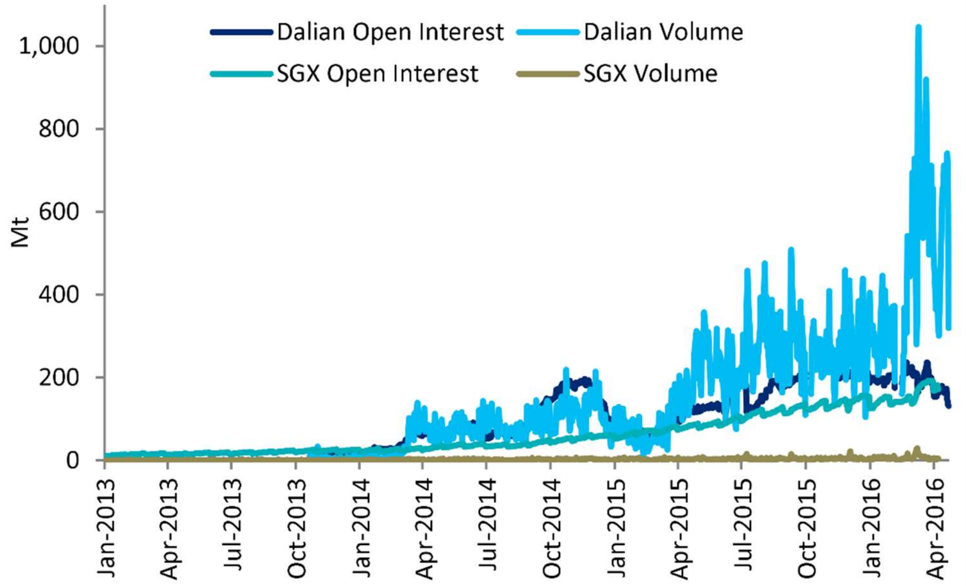


China's money growth data for January 2016 was published on the 16th of February 2016. There had been some prior discussion of stimulus within the domestic Chinese economy. When we saw the lending data in the middle of February, we concluded that pumping the equivalent of A$720bn into an economy in one month was most likely going to have a real effect on construction and hence demand for commodities. We reduced or covered our resource shorts in anticipation of the effect of the stimulus on commodity demand.

What was entirely unanticipated was what has happened since. Trading and leverage in China's commodity exchanges grew such that by April daily turnover exceeded US$260bn (from less than US$80bn in February 2016). To put this in context, at the height of the dotcom boom in 2000, the Nasdaq daily trading volume peaked at US$150bn. Account openings multiplied and commodity day trading volumes increased fivefold. What commenced as stimulus to stabilise an economy became another case study in leverage meeting risk-seeking behaviour, or the human tendency to gamble.

At its peak, over 1 billion tonnes of iron ore was trading *daily* on the Dalian commodity exchange. That is more volume than the 850-900mt Australia is expected to export in 2016. We think it is highly unlikely that the experiment that is currently taking place in commodity markets will end well.

Dalian Commodity Exchange Iron Ore Trading Volumes



Source: Citi

At Auscap we will continue to do what we have always done. We will look for compelling absolute return opportunities, both long and short. If we cannot find sufficiently attractive opportunities, we will wait in cash. Historically we have found that the market throws up opportunities for the patient investor. Liquidity (holding cash) is critical when opportunities arise. Our aim is to invest in businesses at a price that reflects a reasonable absolute prospective return for the risk we are taking by investing in an equity landscape with many variables, unknowns and changing circumstances. Our exposure will always be governed by the opportunity set, and never by a view on what we consider to be unknowable, namely the short term direction of the overall indices.

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