Auscap Long Short Australian Equities Fund Newsletter – May 2017

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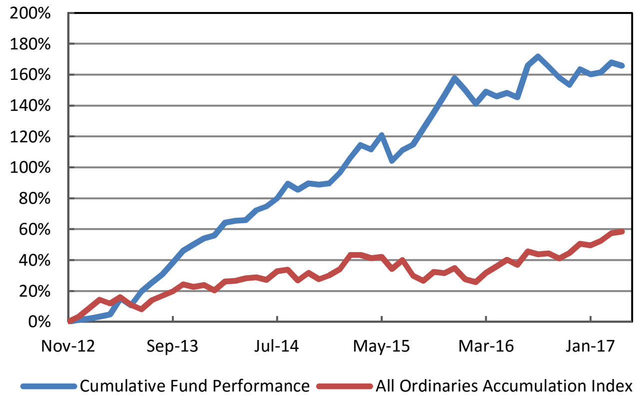
Welcome

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 concept of intrinsic value and its relationship to stock prices.

Fund Performance

The Fund returned negative 0.81% net of fees during April 2017. This compares with the All Ordinaries Accumulation Index return of 0.78%. Average gross capital employed by the Fund was 107.4% long and 20.5% short. Average net exposure over the month was 86.9%. Over the month the Fund had on average 31 long positions and 10 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, financials and consumer discretionary sectors.



Fund Returns

Period	Auscap	All Ords
April 2017	[0.81%]	0.78%
Financial Year to date	8.37%	15.74%
Calendar Year to date	0.90%	5.25%
Since inception	165.82%	58.49%

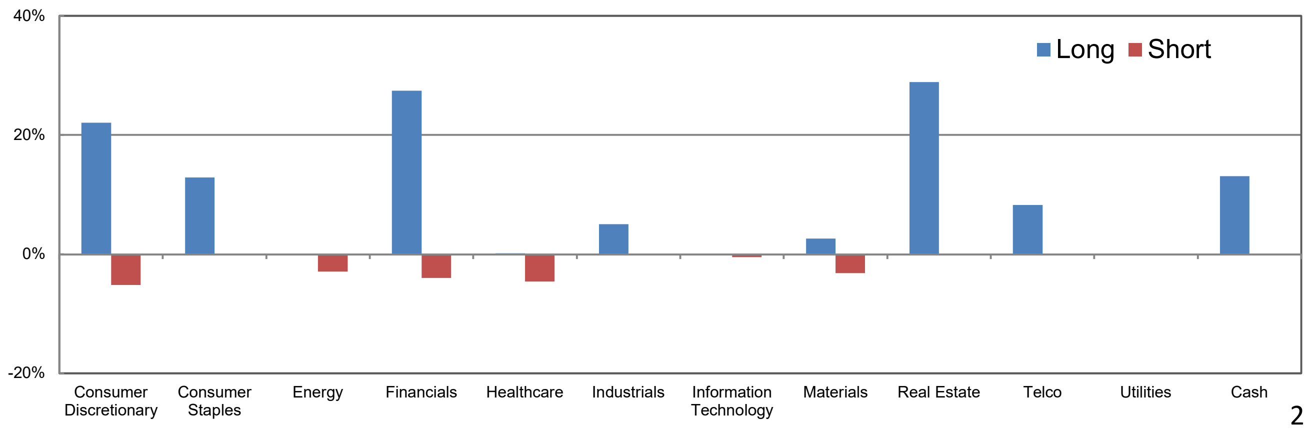
Fund Exposure

April 2017 Average	% NAV	Positions
Gross Long	107.4%	31
Gross Short	20.5%	10
Gross Total	127.9%	41
Net / Beta Adjusted Net	86.9%	43.8%

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)	(1.83)	4.00	(1.20)	0.42	2.52	(0.81)			8.37

Sector Exposure - April 2017



Understanding Intrinsic Value

"The oldest rule in investing is also the simplest: 'Buy low, sell high'. There has to be some objective standard for 'high' and 'low' and most usefully that standard is the asset's intrinsic value. Now the meaning of the saying becomes clear: buy at a price below intrinsic value, and sell at a higher price. Of course, to do that, you'd better have a good idea what intrinsic value is."

Howard Marks, *The Most Important Thing - Uncommon Sense for the Thoughtful Investor*, 2011

Intrinsic value is a frequently used expression within the investment community and the financial media, yet what does it mean? For those of our regular readers who are not financial experts and may not be familiar with the background to this concept, this newsletter provides a brief history of the phrase "intrinsic value" and what it means to buy a stock when it is trading below intrinsic value. We rely on comments and extracts from a number of experts to define the concept and its relevance for investing in financial markets.

The notion of intrinsic value has its roots in the 1930s and 1940s texts of Benjamin Graham who is widely considered to be the "father of value investing". One of Graham's most famous students, Warren Buffett, neatly summarised intrinsic value as follows:

"Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life…. (it) is an estimate rather than a precise figure, and it is additionally an estimate that must be changed if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts, moreover - and this would apply even to Charlie [Munger] and me - will almost inevitably come up with at least slightly different intrinsic value figures."

Warren Buffett

Intrinsic value is what a business is objectively worth. The discounted cash flow model is a common valuation method used to determine a company's intrinsic value. The discounted cash flow model takes into account a company's free cash flow and adjusts future cash flows by the weighted average cost of capital to account for the time value of money.

However, there are also a range of other valuation tools available to investors to estimate the intrinsic value of a business. In Graham's case, he initially looked for stocks that were trading well below liquidation value, assuming that even if the business soured its assets could be liquidated and shareholders would receive more cash than the price paid for the shares.

"Working for Graham from 1946 to 1955, (famous value investor Walter) Schloss's duty was to find stocks that were selling below their working capital – 'net-nets'. The idea behind a net-net is to value a company based on its current net assets by taking cash and cash equivalents at full value, then giving a discount to accounts receivable and inventory, and finally deducting all of the company's liabilities. The net-net value is then derived by dividing the resulting sum by the total shares outstanding. Because financial information was not easily accessible in the old days and investor sentiment was generally poor after the Great Depression, many stocks traded well below their net-net value. Buying these stocks was similar to paying 50 cents for a dollar."

Ronald Chan, *The Value Investors – Lessons from the World's Top Fund Managers*, 2012

"Graham loved his 'net-nets', the stocks he could buy for substantially less than the current assets of the company minus all its liabilities. But in the contemporary investment world, net-nets are, with only the rarest exception, a distant memory. Modern value investors have had to develop new approaches to discovering and valuing assets that allow them to move beyond cash, accounts receivables, and inventory while still making their investment decisions on the basis of the value of the assets today, rather than earnings, cash flow, or whatever in the future."

Bruce Greenwald, Judd Kahn, Paul Sonkin and Michael Van Blema, *Value Investing: From Graham to Buffett and Beyond*, 2001

While net-nets have become more difficult to identify over time, value managers have continued to look for businesses that are trading below their true value. In doing this, they have utilised a number of different tools to estimate intrinsic value. Whilst there is broad recognition that the calculation of intrinsic value is an imperfect science, if you are buying an asset significantly below its intrinsic value there is a margin of safety between the price you are paying and the value of the asset you are purchasing.

"Graham had this concept of value to a private owner – what the whole enterprise would sell for if it were available. And that was calculable in many cases. Then if you could take the stock price and multiply it by the number of shares and get something that was one third or less the sellout value, he would say that you've got a lot of edge going for you. Even with an elderly alcoholic running a stodgy business, this significant excess of real value per share working for you means that all kinds of good things can happen to you. You had a huge margin of safety – as he put it – by having this big excess value going for you."

Charlie Munger, University of Southern California (USC) Business School, 1995 in
Tren Griffin, *Charlie Munger – The Complete Investor*, 2015

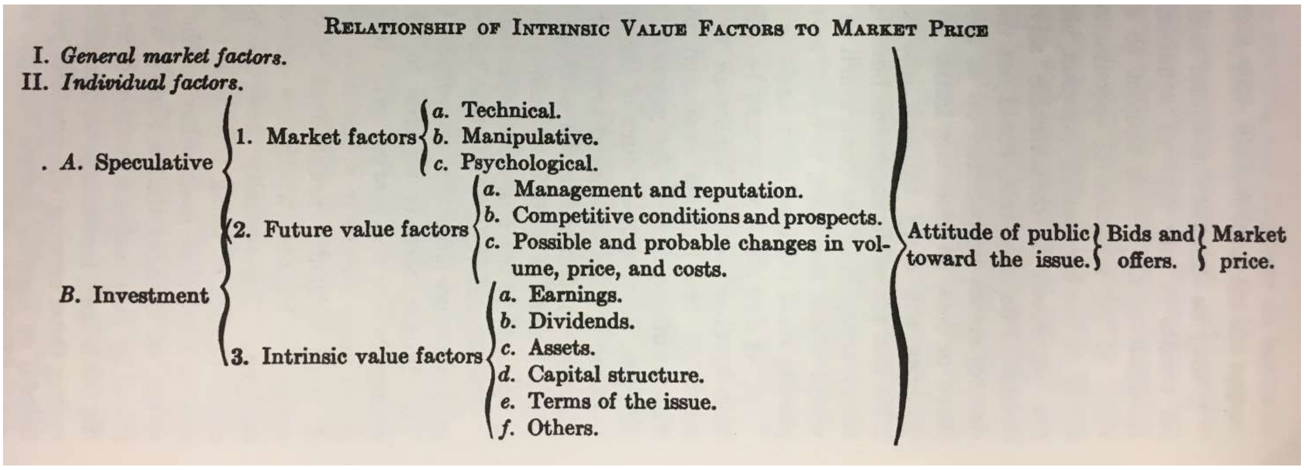
"Valuation is the closest thing to the law of gravity that we have in finance. It's the primary determinant of long-term returns. However, the objective of investment (in general) is not to buy at fair value, but to purchase with a margin of safety. This reflects that any estimate of fair value is just that: an estimate, not a precise figure, so the margin of safety provides a much-needed cushion against errors and misfortunes. When investors violate [this principle] by investing with no margin of safety, they risk the prospect of the permanent impairment of capital."

James Montier, *The Seven Immutable Laws of Investing*, 2011

Stock prices can deviate wildly from their intrinsic value. This is because stock prices are affected by many factors beyond the mere objective calculation of the present value of a business' future cash flows, or the other objective factors which underpin a calculation of intrinsic value. This was explained by Graham and David Dodd in their seminal text, *Security Analysis*.

"The general question of the relation of intrinsic value to the market quotation may be made clearer by the appended chart [see below]*, which traces the various steps culminating in the market price. It will be evident from the chart that the influence of what we call analytical factors over the market price is both partial and indirect – partial, because it frequently competes with purely speculative factors which influence the price in the opposite direction; and indirect, because it acts through the intermediary of people's sentiments and decisions. In other words, the market is not a weighing machine, in which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with its specific qualities. Rather should we say that the market is a voting machine, whereupon countless individuals register choices which are the product partly of reason and partly of emotion."*

Benjamin Graham and David Dodd, *Security Analysis*, 1934



RELATIONSHIP OF INTRINSIC VALUE FACTORS TO MARKET PRICE

I. *General market factors.*
II. *Individual factors.*
A. Speculative
1. Market factors
a. Technical.
b. Manipulative.
c. Psychological.
2. Future value factors
a. Management and reputation.
b. Competitive conditions and prospects.
c. Possible and probable changes in volume, price, and costs.
B. Investment
3. Intrinsic value factors
a. Earnings.
b. Dividends.
c. Assets.
d. Capital structure.
e. Terms of the issue.
f. Others.
Attitude of public toward the issue.
Bids and offers.
Market price.

The attractiveness of an opportunity depends on an investment manager's ability to calculate a reliable estimate of intrinsic value for a given company, and whether the price of the stock of that company is trading well below that intrinsic value for speculative reasons.

"For investing to be reliably successful, an accurate estimate of intrinsic value is the indispensable starting point. Without it, any hope for consistent success as an investor is just that: hope."

Howard Marks, *The Most Important Thing - Uncommon Sense for the Thoughtful Investor*, 2011

Calculating an estimate of intrinsic value is sometimes more easily said than done. We tend to shy away from instances where we find it too difficult to do so, whether it be due to the complexity of the business model or the difficulty in making sensible forward assumptions. Any calculation of intrinsic value will also necessarily be an approximation, rather than a specific number, and will change over time as circumstances change.

"The essential point is that security analysis does not seek to determine exactly what is the intrinsic value of a given security. It needs only to establish either that the value is adequate… to justify a stock purchase – or else that the value is considerably higher or considerably lower than the market price."

Benjamin Graham and David Dodd, *Security Analysis*, 1934

As value managers, at Auscap we aim to purchase shares in businesses when they trade at prices that are below our estimate of intrinsic or fair value. In this way we strive to generate compounding returns for our investors over time. This is not an original concept and we endeavour to continue to learn from the successful value investors who have shared and continue to share their accumulated wisdom.

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