Auscap Long Short Australian Equities Fund Newsletter – February 2017

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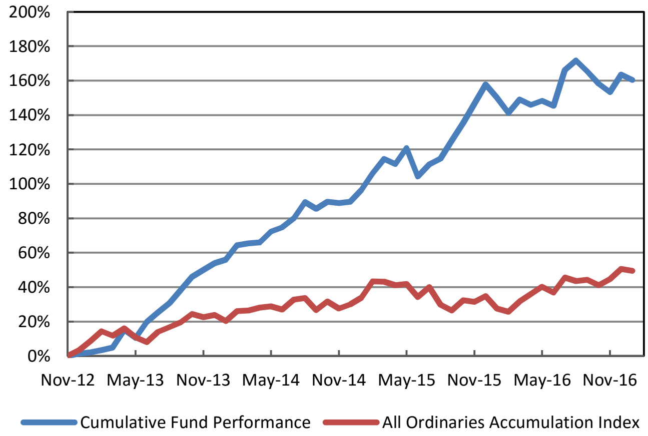
Welcome

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 how leverage has continued to increase post the Global Financial Crisis in various ways across different countries.

Fund Performance

The Fund returned negative 1.20% net of fees during January 2017. This compares with the All Ordinaries Accumulation Index return of negative 0.77%. Average gross capital employed by the Fund was 131.6% long and 16.8% short. Average net exposure over the month was 114.8%. At the end of the month the Fund had 34 long positions and 6 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, financials, consumer discretionary and telecommunications sectors.



Fund Returns

Period	Auscap	All Ords
January 2017	[1.20%]	[0.77%]
Financial Year to date	6.12%	9.12%
Calendar Year to date	[1.20%]	[0.77%]
Since inception	160.30%	49.43%

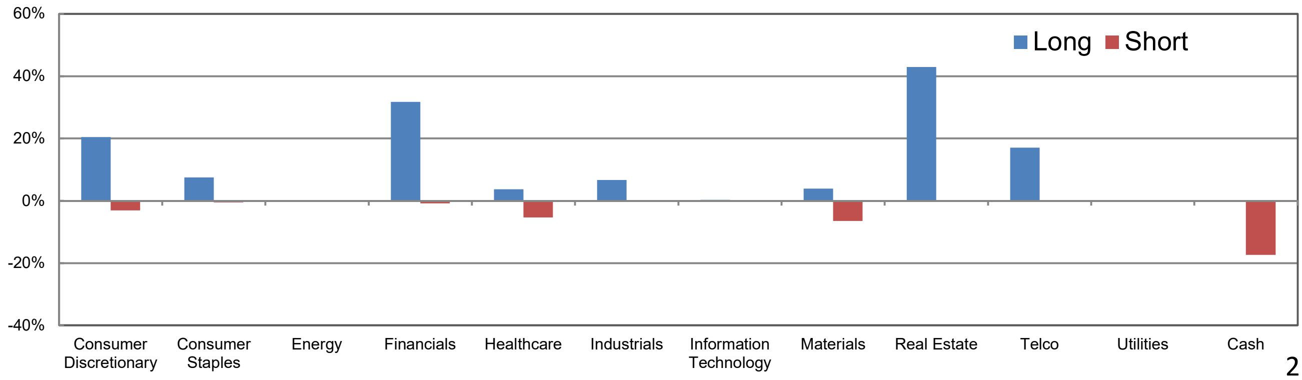
Fund Exposure

January 2017 Average	% NAV	Positions
Gross Long	131.6%	35
Gross Short	16.8%	8
Gross Total	148.4%	43
Net / Beta Adjusted Net	114.8%	77.9%

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)						6.12

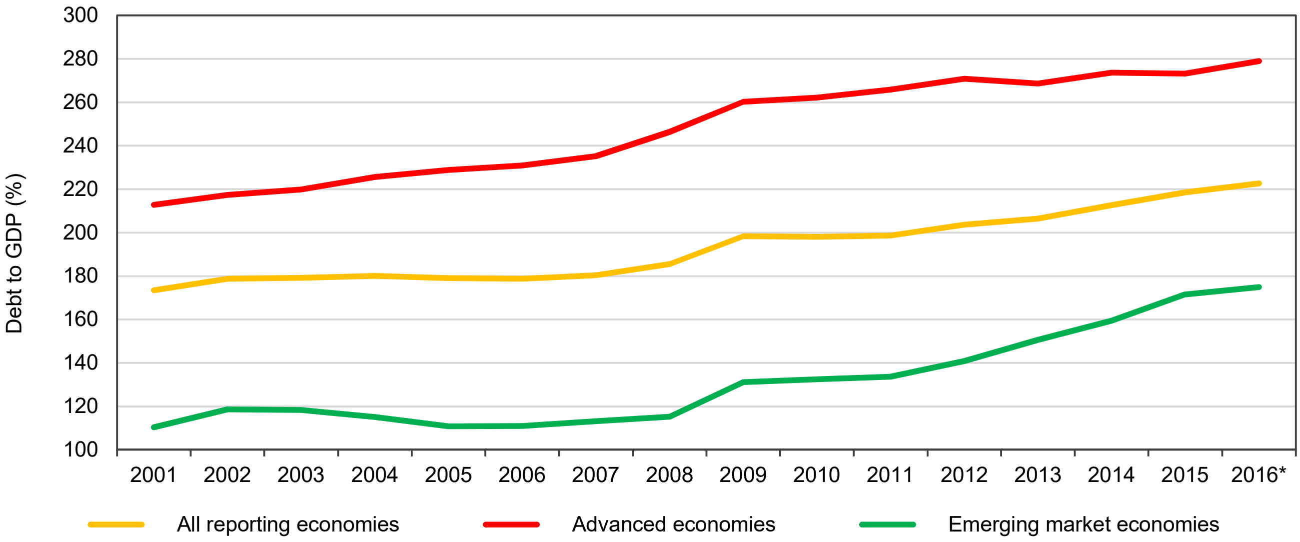
Sector Exposure - January 2017



Unintended consequences of ultra-low interest rates

Have low interest rates in the major developed world economies caused asset bubbles in the emerging economies around the globe? What might the consequences of this be? Can leverage ratios continue to increase to support growth? What will happen if interest rates rise? How should this affect our thinking about investing? These are questions that are currently on the minds of many. While we do not purport to know any of the answers as to how the future unfolds, and do not invest on the basis of macroeconomic views, we can analyse the leverage data to potentially draw some sensible conclusions.

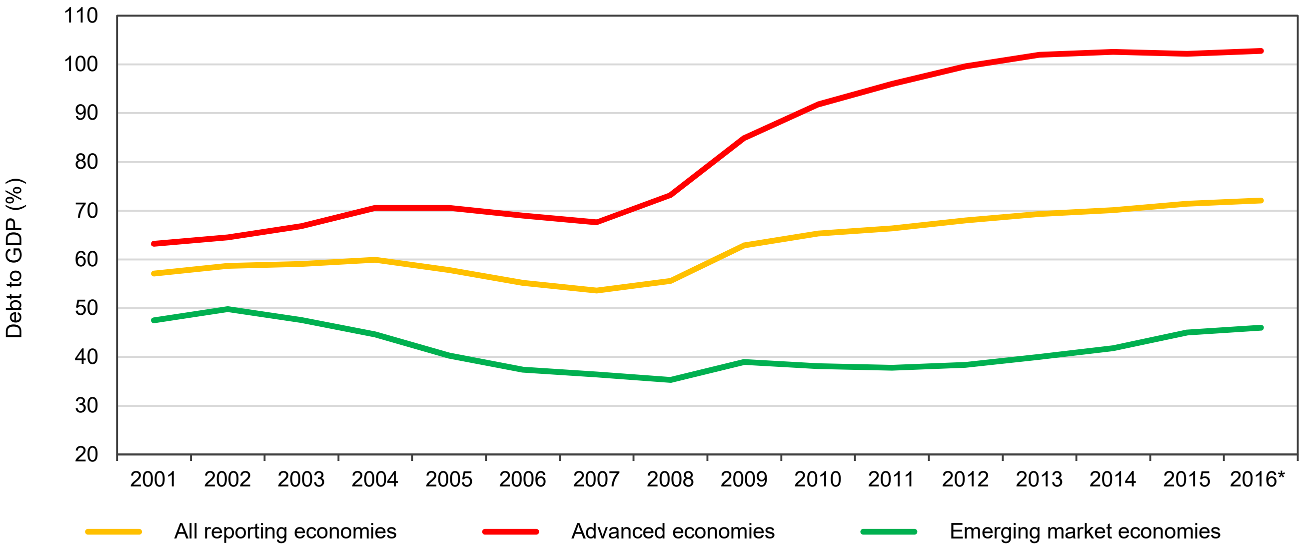
Debt to GDP (2001 - mid 2016)



Source: Bank for International Settlements, Auscap Asset Management
* 2016 is mid-year data

The world has a lot of debt. And leverage has continued to increase post the Global Financial Crisis. The average national economy now has a debt to Gross Domestic Product (GDP) ratio of almost 223%. It is higher for advanced economies at 279%, and lower for emerging market economies at 175%. Albeit emerging market economies' debt levels are growing faster, with a 65% increase in their debt to GDP ratio since 2001 compared with 49% for advanced economies.

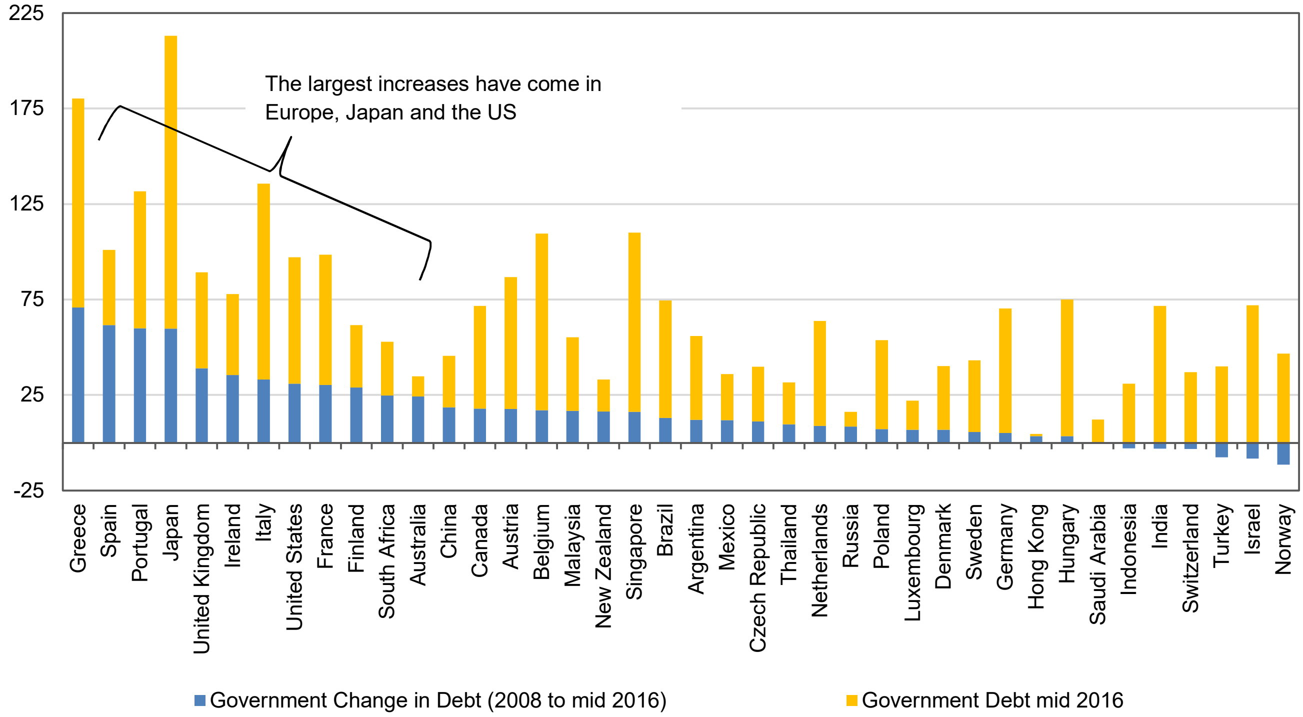
Government Sector Debt to GDP (2001 - mid 2016)



Source: Bank for International Settlements, Auscap Asset Management

Almost all of the growth in debt in advanced economies in recent years has come from an increase in Government debt. It is probably no surprise that Government debt has increased most quickly in countries within Europe and in Japan and the United States, being those most affected by the Global Financial Crisis. Governments increased spending and took on considerably more debt to reduce the severity of the crisis.

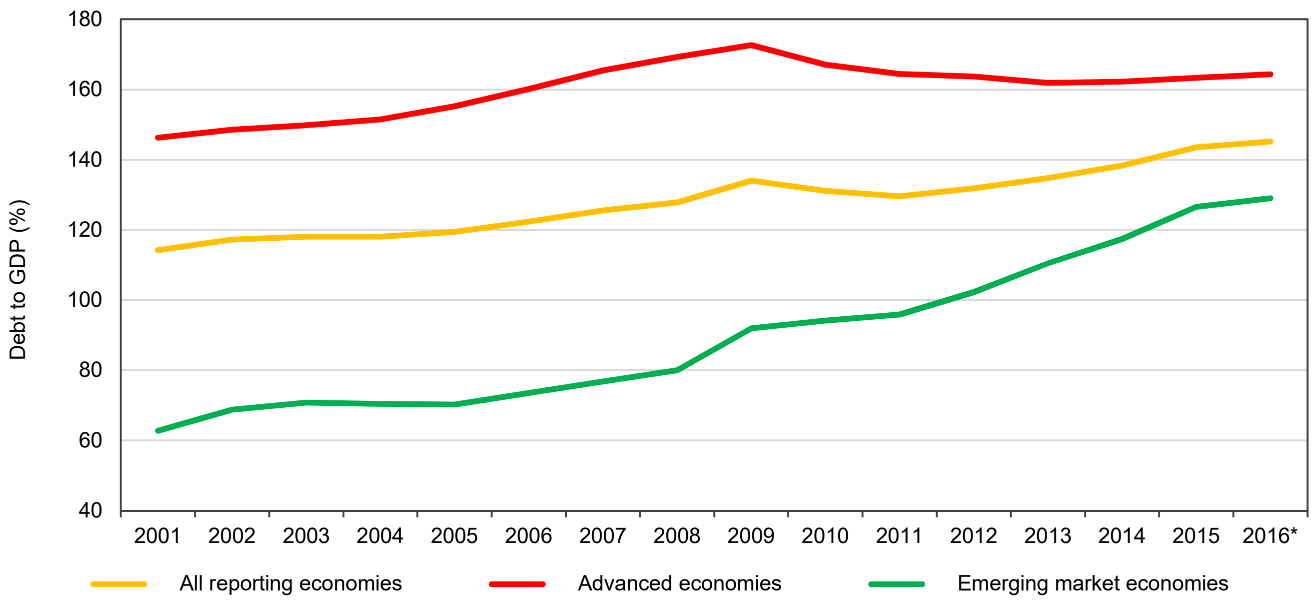
Government Sector Debt (% of GDP)



Source: Bank for International Settlements, Auscap Asset Management

In that same period many advanced economies saw limited private sector debt growth, although the variance at the country level is quite significant. Emerging markets by contrast continued to embrace private sector leverage, with ratios now quickly approaching levels seen in the advanced economies.

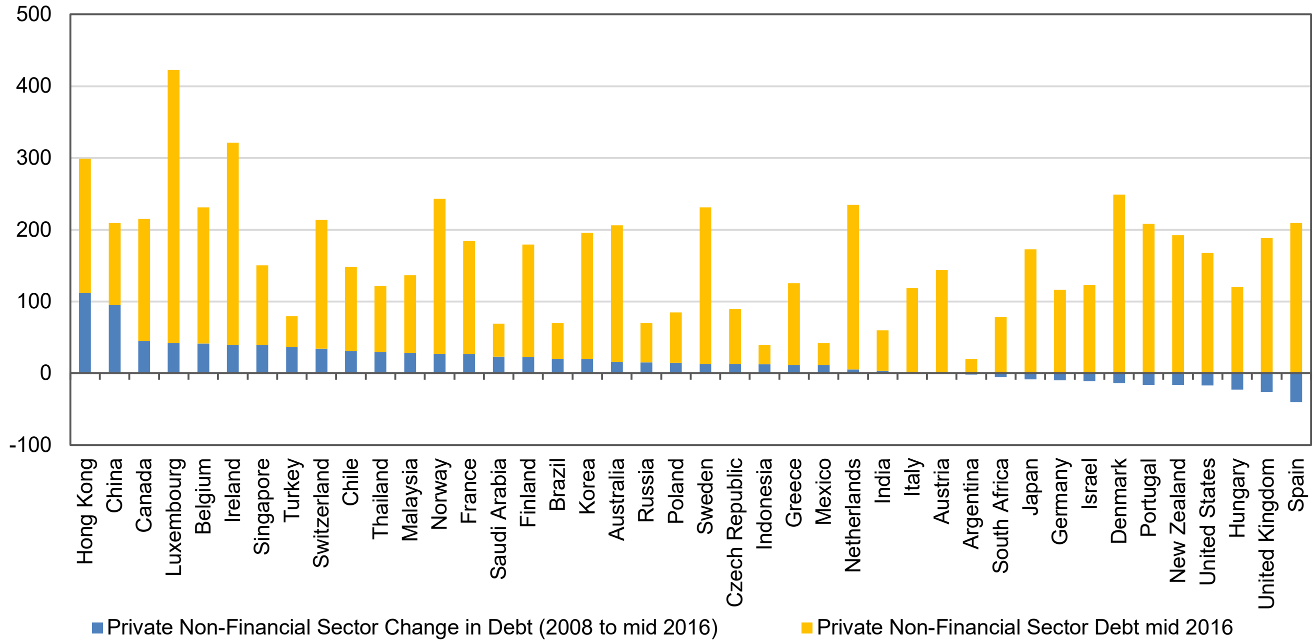
Private Sector Debt to GDP (2001 - mid 2016)



Source: Bank for International Settlements, Auscap Asset Management

While increases in private sector leverage have been most apparent in Hong Kong and China, increases in private sector leverage have not been restricted to emerging market economies. Many advanced economies that are beneficiaries of emerging market growth have also seen a material increase in private sector leverage, including Canada and Singapore.

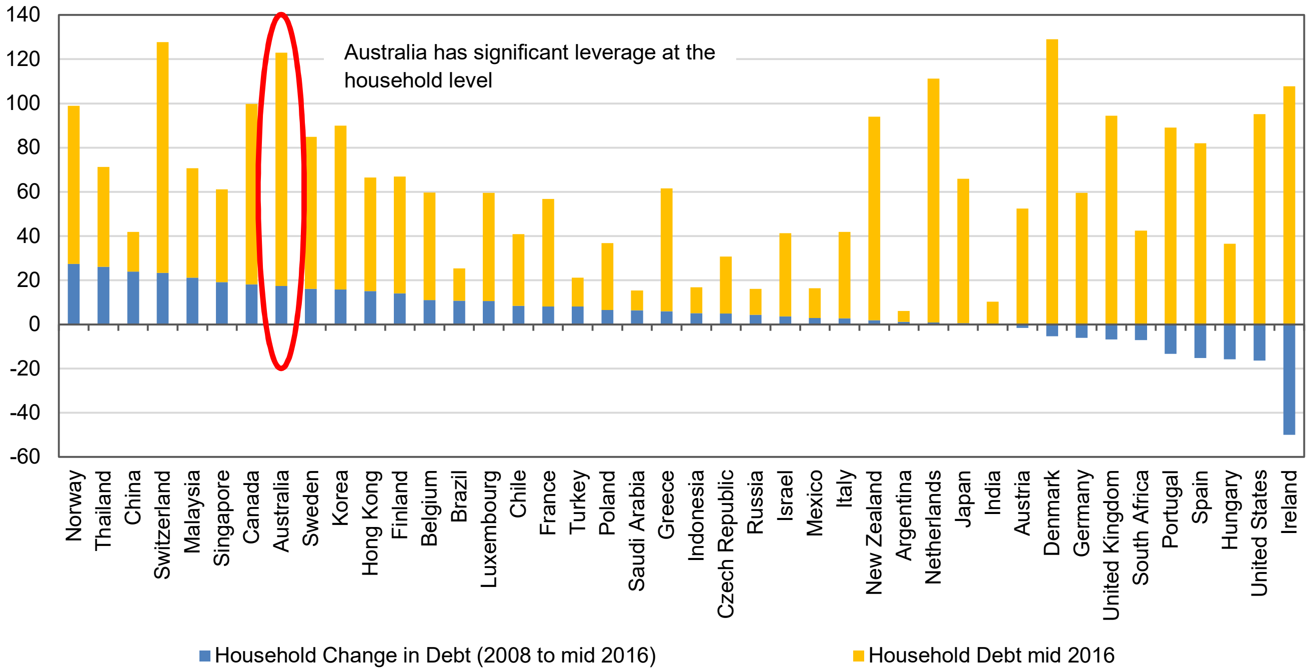
Private Non-Financial Sector Debt (% of GDP)



Source: Bank for International Settlements, Auscap Asset Management

The nature of the accumulated private sector leverage is quite different across different countries. In Australia the increase in private non-financial sector debt has been entirely driven by the household sector, with corporations carrying less leverage today than in 2008.

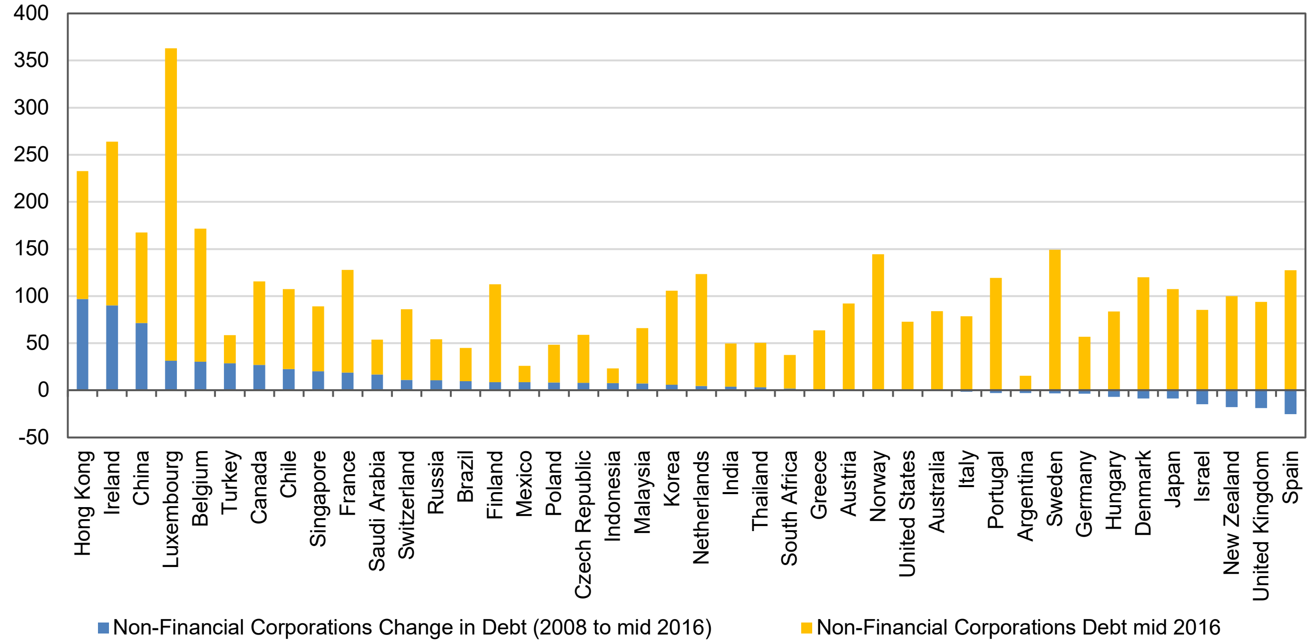
Household Sector Debt (% of GDP)



Source: Bank for International Settlements, Auscap Asset Management

In China and Hong Kong the increase in debt has been broad based, but driven in particular by a significant increase in corporate leverage. This increase in leverage has provided a meaningful boost to economic growth. China currently has one of the highest levels of corporate sector debt in the world.

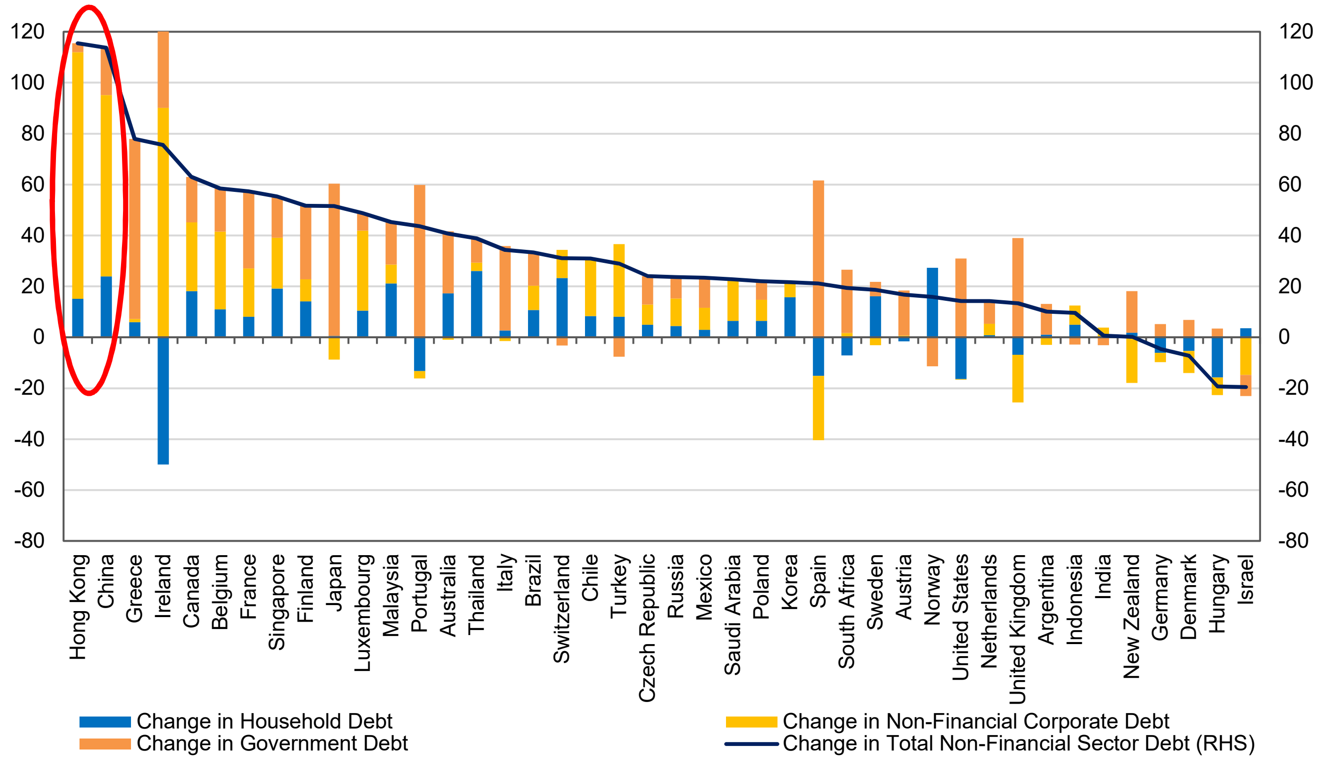
Non-Financial Corporation Debt (% of GDP)



Source: Bank for International Settlements, Auscap Asset Management

Indeed the increase in global leverage since 2008 has been most pronounced in China and Hong Kong. Both Hong Kong and China have seen an increase in their non-financial sector debt to GDP ratios of over 100%.

Change in Non-Financial Sector Debt (% of GDP - 2008 to mid 2016)



Source: Bank for International Settlements, Auscap Asset Management

What the future consequences of this accumulation of debt will be is unclear. We do not attempt to make forecasts or predictions about the events that might follow from high leverage in the same way that we do not pretend to have any insight into the direction of equities markets, bond markets, currency markets or the impact of President Trump, Brexit or any other unforeseen event. We would never make an investment based on a macroeconomic view that is more opinion than fact. Trying to work out the consequences of excessive leverage is a very difficult exercise and has left many a forecaster red-faced.

We focus more on what the data might be telling us to do and, sometimes more importantly, what not to do. We avoid markets, industries, sectors, companies and occasionally material exposure to entire economies that have too much debt. In this way, if leverage becomes an issue, while it might impact sentiment and, over time, the broader economy, it does not put our investments directly at risk of a shortage of credit or a sudden rise in interest rates that could affect the viability of the businesses we have shared ownership in. Sometimes the data speaks most clearly in telling us what to avoid, particularly in relation to the macroeconomic data. While we try to avoid predicting unknowable outcomes, we do focus on maintaining discipline with respect to minimising exposure to significant risks as identified through our analysis.

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