Auscap Long Short Australian Equities Fund Newsletter – June 2017

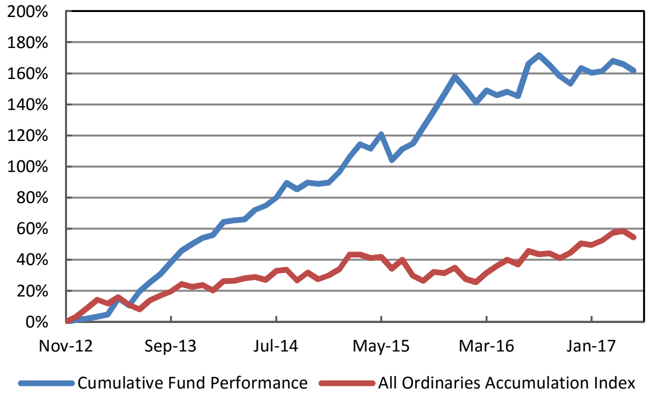
The Auscap Long Short Australian Equities Fund has been rated "Recommended" by Zenith and Lonsec. Interested wholesale and professional investors can download a copy of each report from the Auscap website www.auscapam.com.

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 cash position of the Fund and how it reflects the opportunity set rather than any view on the direction of the stockmarket.

Fund Performance

The Fund returned negative 1.53% net of fees during May 2017. This compares with the All Ordinaries Accumulation Index return of negative 2.58%. Average gross capital employed by the Fund was 87.4% long and 21.5% short. Average net exposure over the month was 65.9%. Over the month the Fund had on average 27 long positions and 9 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
May 2017	[1.53%]	[2.58%]
Financial Year to date	6.72%	12.75%
Calendar Year to date	[0.64%]	2.53%
Since inception	165.82%	54.40%

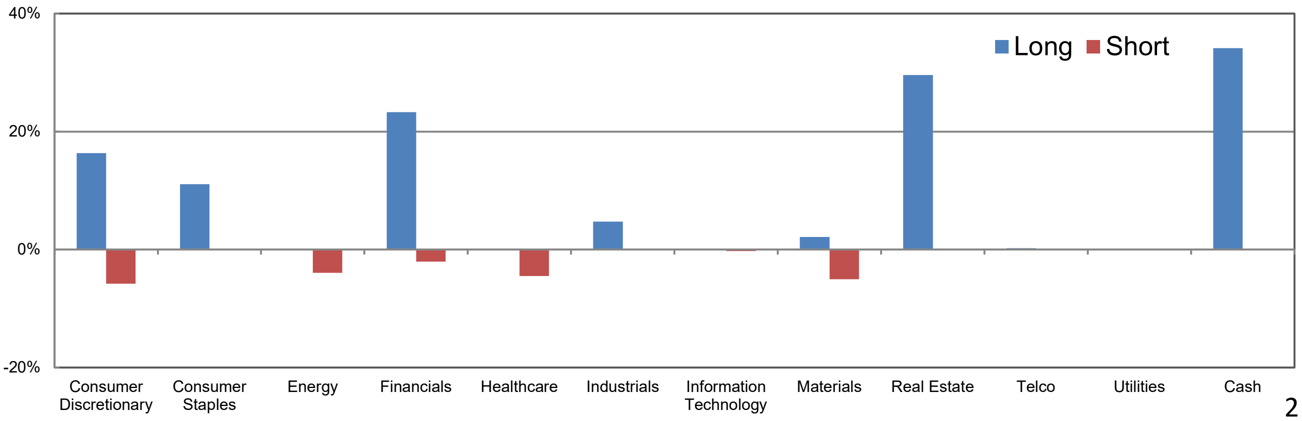
Fund Exposure

May 2017 Average	% NAV	Positions
Gross Long	87.4%	27
Gross Short	21.5%	9
Gross Total	108.9%	36
Net / Beta Adjusted Net	65.9%	24.1%

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)	(1.53)		6.72

Sector Exposure - May 2017



Is holding cash a decision or an output?

Investors may have noticed that the Fund currently holds quite a lot of cash. Despite averaging a little over 87% long over the last month, the Fund has over 30% of its assets held in cash due to the cash we receive from our shorts. As managers we are not averse to holding significant levels of cash. This has been demonstrated at different times over the life of the Fund. During the first half of 2016 the Fund averaged over 50% net cash. We consider holding cash a far better alternative to holding low conviction investments.

Low conviction investments tend to cost investors mental and physical capital. We speak from experience when we say that mistakes are more easily made and capital more likely to be forfeited when investing with low conviction. The market has a way of testing your investment thesis and conviction at some point for every stock that you own. If you do not have high conviction in your investments, if there are unanswered questions in the back of your mind about a particular company, you are considerably more prone to exiting at the moment of maximum market pessimism, when it appears that you misjudged the opportunity, whether or not that is actually the case. The exit at the point of maximum negativity crystalises a permanent loss of capital. The effort spent considering your investment during ownership has also no doubt cost you considerable mental capital, taking energy away from a more productive use of your time, such as considering other opportunities.

By contrast, cash gives an investor optionality to take advantage of opportunities as and when they arise. It provides clarity of thought to consider investing at those moments of maximum market or stock specific pessimism. It also gives flexibility to deploy capital quickly when a stock, sector or the market declines for reasons that are transitory or not likely to impact the earnings of a particular company.

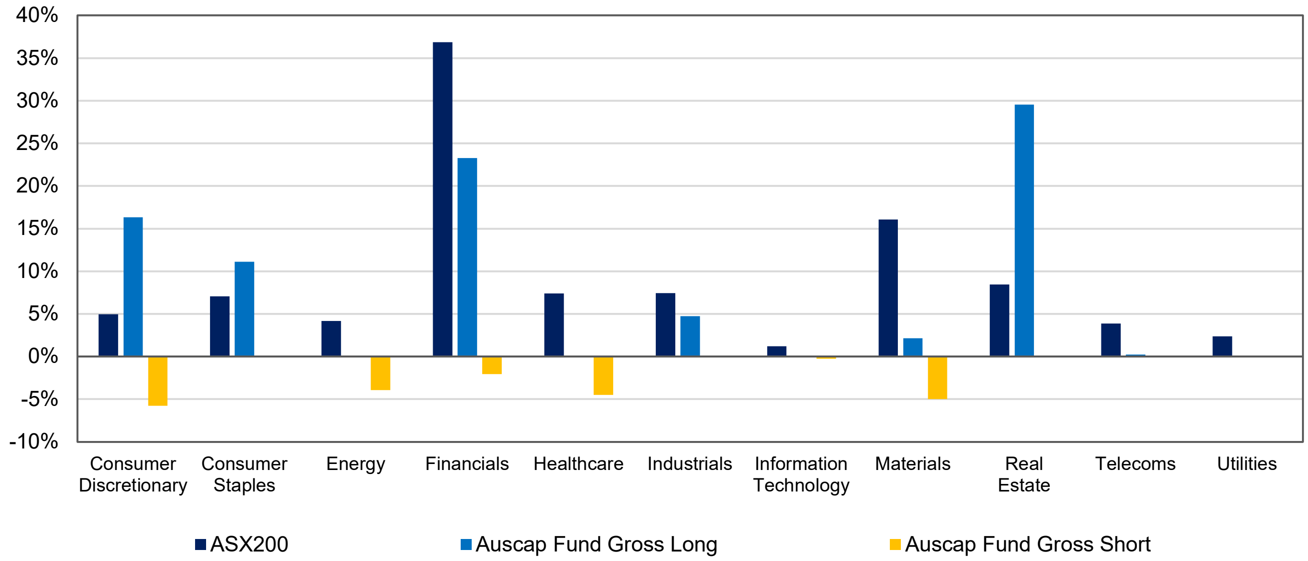
Auscap's cash holding should not be interpreted as a sign that we are bearish on the broader market. In fact, very infrequently will we have a strong opinion on the direction of the major indices. We have no special insight into the direction of the stock prices of the biggest companies that constitute the bulk of the domestic sharemarket. Certainly we are not currently holding cash due to any bearish views that we hold.

If we *were* to put forward a view on the broader market, we might suggest that it does not currently look particularly cheap or expensive. It is trading slightly above its average future multiple of earnings compared with recent history. However, one could make the case that stocks look relatively attractive compared to the other major asset classes. There is no broad market euphoria that is consistent with market peaks outside a few small sectors where consensus opinion is matched with lofty growth expectations. When valuations become stretched we are generally sellers of such assets.

The flipside is that our economy faces a number of challenges following decades of uninterrupted prosperity. Growth may be more challenging in the immediate aftermath of a resources and residential property boom. Many of the major sectors within the market are facing considerable headwinds and/or structural changes with uncertain outcomes. We choose not to invest in businesses with considerable headwinds unless the assets are being priced attractively for the nature and quantum of the risk. Even then we are careful to reassess our analysis on a regular basis.

These somewhat generic comments, which we consider to be of questionable value, do not dictate what cash is held in the Fund. Our cash holding is always an output of the decision making process, not an input. It is the result of the individual company opportunity set as we see it. Every opportunity is assessed on its merits on an absolute return basis. We do not care much for relative performance. We are completely index agnostic. As can be seen in the chart below, the Fund composition looks nothing like that of the Australian stockmarket. We care about absolute return in the context of the investment risk we are taking. When we are seeing a lot of attractive investment opportunities the Fund will be close to fully invested. When we are not seeing as many investment opportunities we will sit patiently with higher cash levels.

Auscap Fund May 2017 sector exposures compared to ASX200



It is important to remember that the market has no responsibility to present us with opportunities just because we have cash to deploy. We do not try to force the issue. Opportunities will come to the patient and disciplined, they cannot be manufactured. In 2016 our greatest deployment of capital came in the weeks following Brexit, an event we certainly did not predict or position the portfolio for, but could take advantage of because our cash levels were quite substantial. Invariably, sitting on cash gives a manager the ability to generate outsized returns when opportunities do present themselves. In those moments having access to cash and the ability to deploy it quickly can generate the most value for unitholders.

In a similar vein, the market has no obligation to recognise the true value of an investment, as we perceive it to be, immediately after our purchase. This might seem obvious, but it is the long term results of a manager that will indicate the quality of its investment decisions. In the short term performance is as much a function of which stocks are in favour, which sectors have short term tailwinds and which style is popular at that particular point in time. In the long term it is derived from buying undervalued securities and waiting patiently for the market to recognise their value over time (or the converse for our short positions). The advantage we have in purchasing companies that generate significant levels of cash is that we get paid to wait. Our long investments generate substantial cash flow after all business capital expenditure and pay us growing dividends. Cash generation is the friend of the long term investor.

At Auscap we will continue to hold cash in the absence of compelling investment propositions. Holding surplus cash provides us with optionality to take advantage of opportunities as and when they arise. It is often these opportunities that generate the most long term value for our investors.

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Auscap Asset Management Limited

ACN 158 929 143 AFSL 428014
Lvl 30, 9 Castlereagh St, Sydney

Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
Administration: White Outsourcing

Tax & Audit: Ernst & Young
Legal: Henry Davis York