Auscap Long Short Australian Equities Fund Newsletter – October 2017

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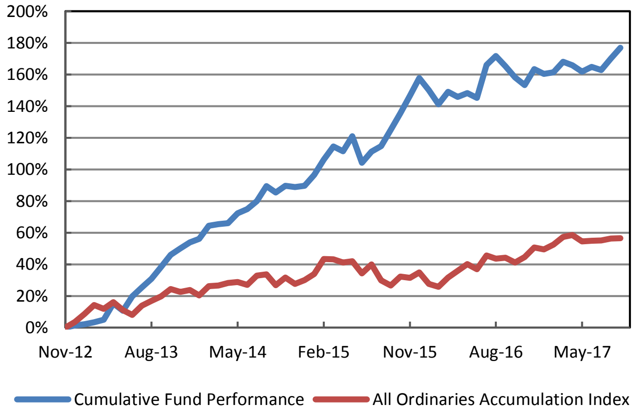
Welcome

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 circumstances under which we typically find compelling value-based opportunities for investment.

Fund Performance

The Fund returned 2.53% net of fees during September 2017. This compares with the All Ordinaries Accumulation Index return of 0.05%. Average gross capital employed by the Fund was 114.6% long and 6.1% short. Average net exposure over the month was 108.5%. Over the month the Fund had on average 34 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, financials and consumer sectors.



Fund Returns

Period	Auscap	All Ords
September 2017	2.53%	0.05%
Financial Year to date	4.54%	1.02%
Calendar Year to date	5.10%	3.87%
Since inception	176.87%	56.42%

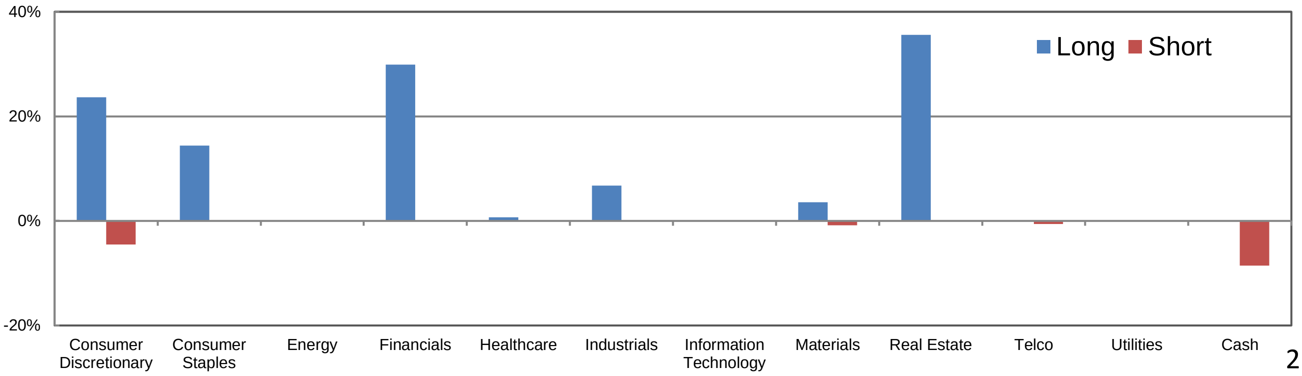
Fund Exposure

September 2017 Average	% NAV	Positions
Gross Long	114.6%	34
Gross Short	6.1%	7
Gross Total	120.7%	41
Net / Beta Adjusted Net	108.5%	73.1%

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)	1.18	7.97
FY18	(0.77)	2.75	2.53										4.54

Sector Exposure - September 2017



Are There Opportunities For An Active Manager In An Efficient Market?

We view the domestic stockmarket as one that is highly efficient. There are a large number of domestic research analysts, brokers, fund managers and investment professionals poring over the listed securities. In such an environment it is very difficult, if not impossible, to regularly be smarter than the other informed market participants. So how is an individual stock picker going to outperform over long periods of time? Why would such a market present outstanding individual risk-adjusted opportunities for investors? It is a good question to ask if you are invested with an active manager. It has been a key question for researchers for some time and led to Professor Eugene Fama's Efficient Market Hypothesis (EMH) which proposed that it is impossible to beat the performance of a liquid stockmarket over time because prices constantly incorporate and reflect all relevant information.

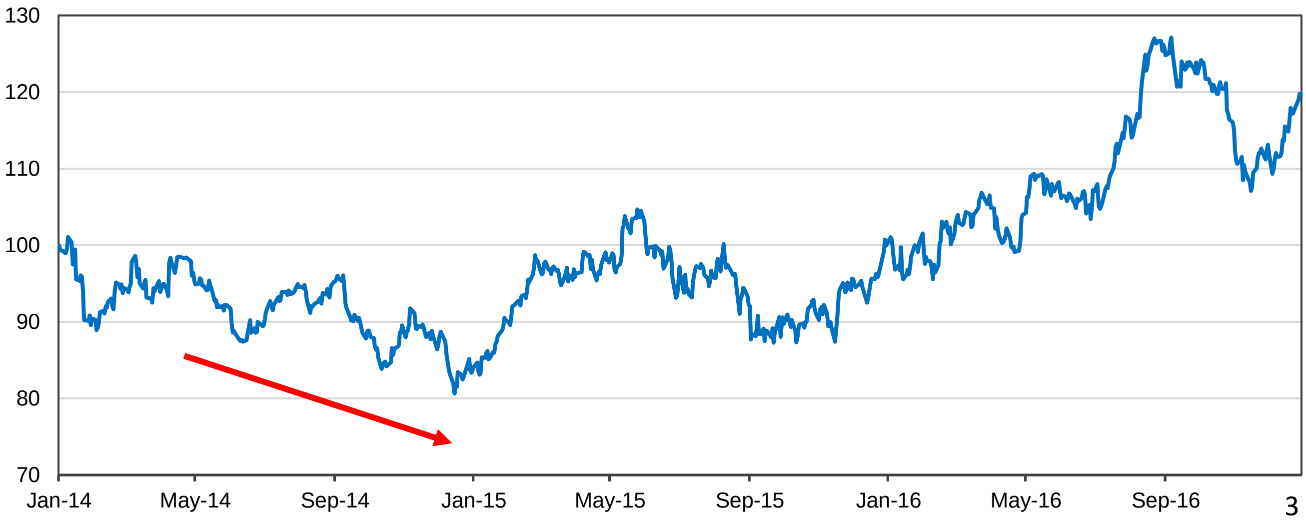
If we find a stock that we think is compellingly cheap, one of the first questions we ask is why we are getting the opportunity. What circumstances have led to the mispricing? What are people reacting to in order for the stock price to have deviated so far from our perception of fair value? It is an important question. The absence of a logical answer might infer a problem with the analysis, rather than an opportunity for an attractive purchase. After all, the collective market is almost always more informed than the individual investor, assuming the investor is an outsider to the company under consideration.

We think we get opportunities for one predominant reason. Market participants have cognitive biases that lead to emotional rather than rational responses to new or changing circumstances. We are no different. We feel the same emotional responses. But we view our role as trying to act and invest as rationally as possible. We focus our attention on the facts of the situation and try to remove the influence of the emotional response from our thinking.

The opportunities that we get typically come in one of three forms. The first is at the stock level. A company has a temporary setback, issue or earnings revision and the market extrapolates the problem across the entire business. We focus on the medium term outlook for the business and ask whether we can make sensible, modest forecasts about earnings over the following few years and whether, if the earnings are delivered as expected, this would make buying at the current stock price a highly attractive purchase. If we can answer that in the affirmative, then we take advantage of this time horizon arbitrage to buy into businesses we would like to own for a long time.

Similarly, sometimes a whole sector might screen as attractively priced because the market is focused on a threat that would appear overblown based on a thorough analysis.

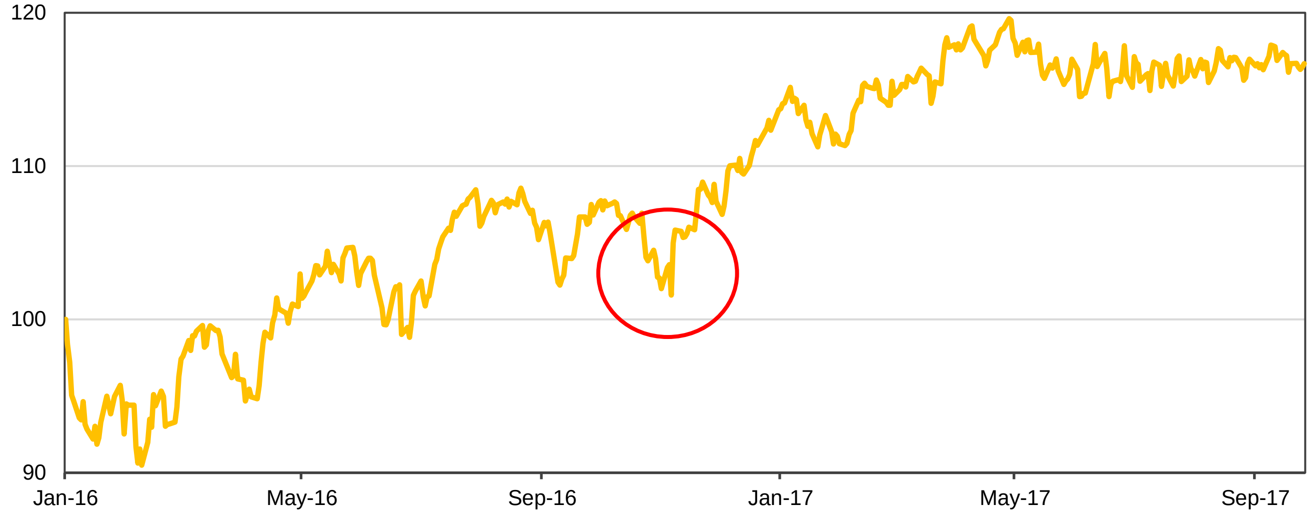
ASX200 Retail Index 2014 - 2016



In May 2014 the Federal Government proposed a restrictive and somewhat unpopular budget to assist in repairing the budget deficit. As shown on the previous page, over the following six months the market reacted by selling down retail stocks that many assumed would be significantly impacted by any cut to disposable income. The likely numerical impact of any budget measures on consumer discretionary spend was, on our analysis, going to be small and transitory in nature. So the market reaction to the announcement gave us an attractive entry point into a number of high quality retailers that we had been watching for some time.

Then occasionally there will be a market wide reaction to a particular event, such as the surprise election of Donald Trump as US President or the UK referendum which resulted in a vote in favour of Brexit. Participants in the domestic market reacted to Brexit by selling financial stocks in the weeks that followed. Most of these stocks were down considerably despite, in our opinion, the risks to corporate earnings being relatively low. Similarly, it was unclear why the election of President Trump would negatively impact the earnings of Australian companies, yet at one point in the afternoon of the election the domestic stockmarket was down nearly 4% (as highlighted below), with many individual stocks down considerably more than this, having already fallen on the uncertainty of the outcome heading into the election.

All Ordinaries Accumulation Index 2016 - 2017



Outstanding opportunities do not come along frequently, and certainly not predictably. So our aim in the intervening periods is to be as patient as possible, remaining focused on our existing portfolio and ready to respond rationally if we do get an opportunity to invest sensibly in companies we are highly familiar with that have the quality attributes we look for in good businesses. As many market minds have postulated before us, we agree with the notion that the market is most often efficient, but that the difference between “often” and “always” is like night and day. Opportunities for the value investor occur when the majority of market participants are distracted from the immediate opportunity by an issue where the impact is either exaggerated or transitory in nature. This is when we become most interested and plan to take full advantage for the long term benefit of our unitholders.