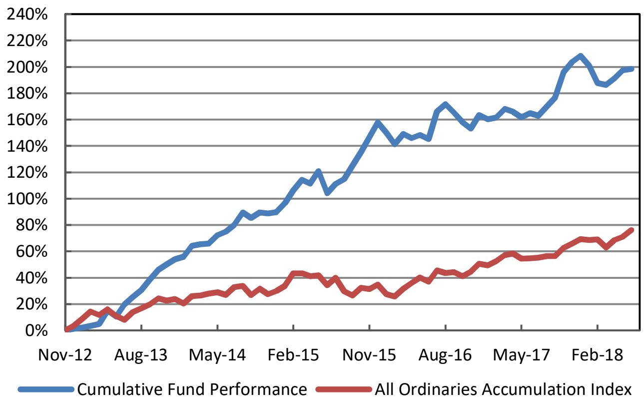
Auscap Long Short Australian Equities Fund Newsletter – July 2018

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 housing credit growth and assess a few potential implications of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Fund Performance

The Fund returned 0.39% net of fees during June 2018. This compares with the All Ordinaries Accumulation Index return of 2.95%. Average gross capital employed by the Fund was 83.1% long and 38.3% short. Average net exposure over the month was 44.8%. Over the month the Fund had on average 26 long positions and 16 short positions. The Fund's biggest stock exposures at month end were spread across the consumer, financials and real estate sectors.



Fund Returns

Period	Auscap	All Ords
June 2018	0.39%	2.95%
Financial Year to date	12.71%	13.72%
Calendar Year to date	(3.24%)	4.04%
Since inception	198.52%	76.08%

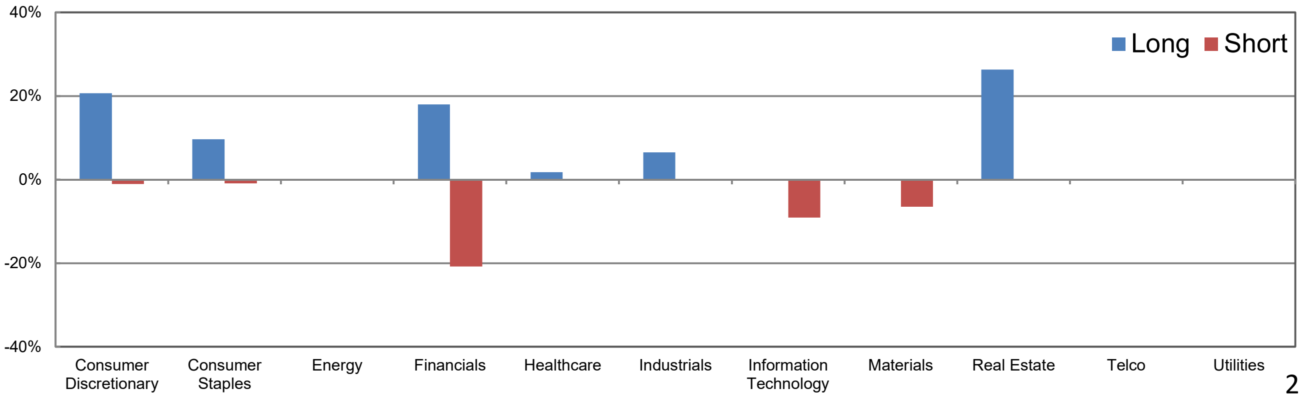
Fund Exposure

June 2018 Average	% NAV	Positions
Gross Long	83.1%	26
Gross Short	38.3%	16
Gross Total	121.4%	42
Net / Beta Adjusted Net	44.8%	19.8%

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)	(1.53)	1.18	7.97
FY18	(0.77)	2.75	2.53	6.96	2.58	1.56	(2.50)	(4.31)	(0.56)	1.75	2.11	0.39	12.71

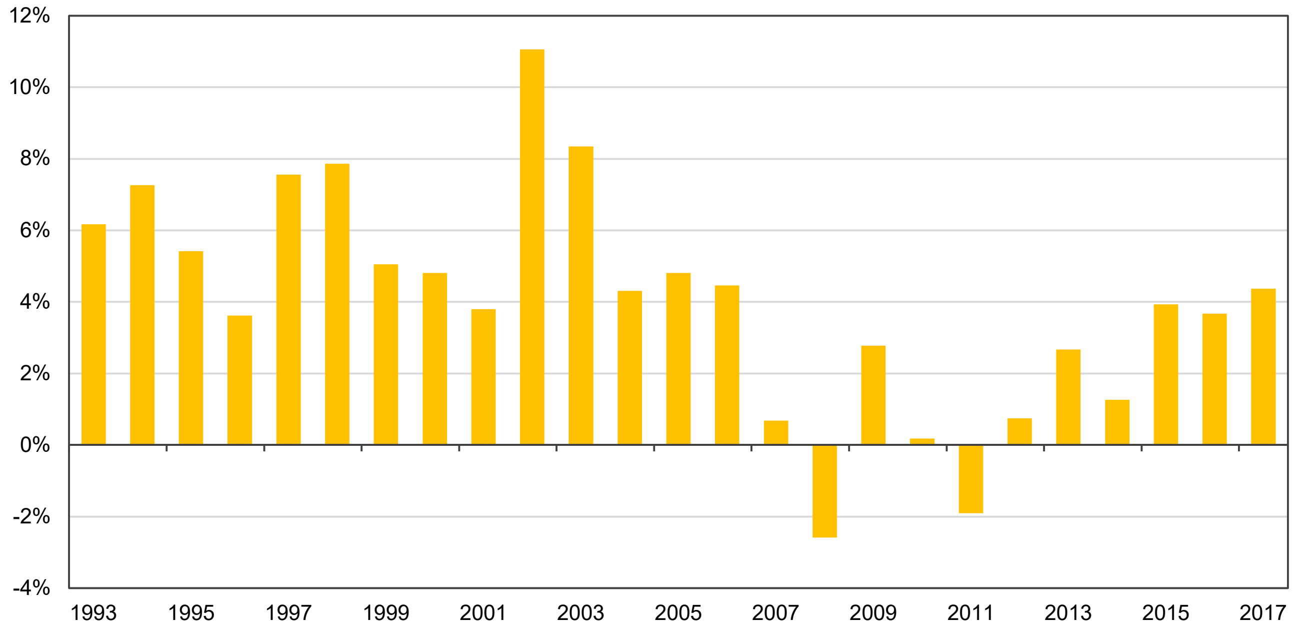
Sector Exposure - June 2018



Will The Royal Commission End The Leverage Obsession?

Australians appear to be addicted to leverage. Specifically, housing leverage. In 23 of the last 25 years, Australian household leverage has increased. That is, the average household has borrowed more money for the same dollar of income. The debt to income ratio has continued to rise, with only occasional pauses. Will this continue into perpetuity? We are reminded of a famous German proverb, *"trees don't grow to the sky"*.

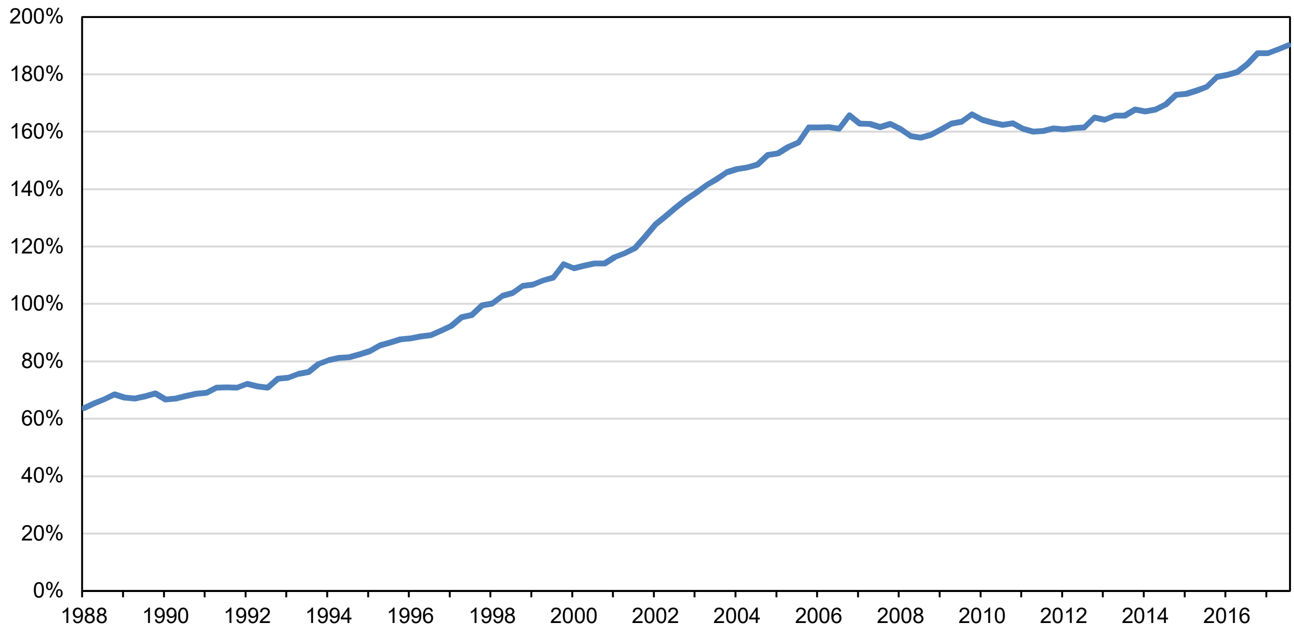
Change in Household Leverage (Household Debt to Income Ratio)



Source: Reserve Bank of Australia, Auscap

Household debt as a percentage of disposable income now exceeds 190%.

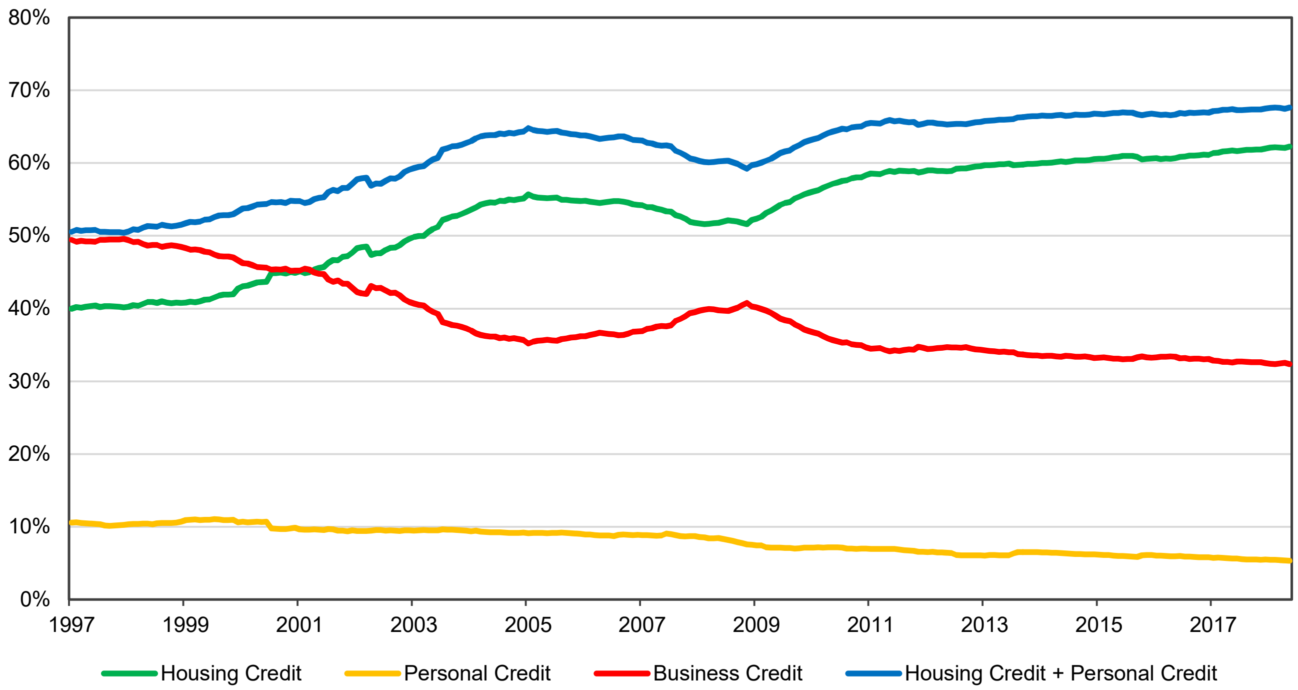
Household Debt As A Percentage Of Disposable Income



Source: Reserve Bank of Australia, Auscap

Housing credit is now over 62% of total private sector credit.

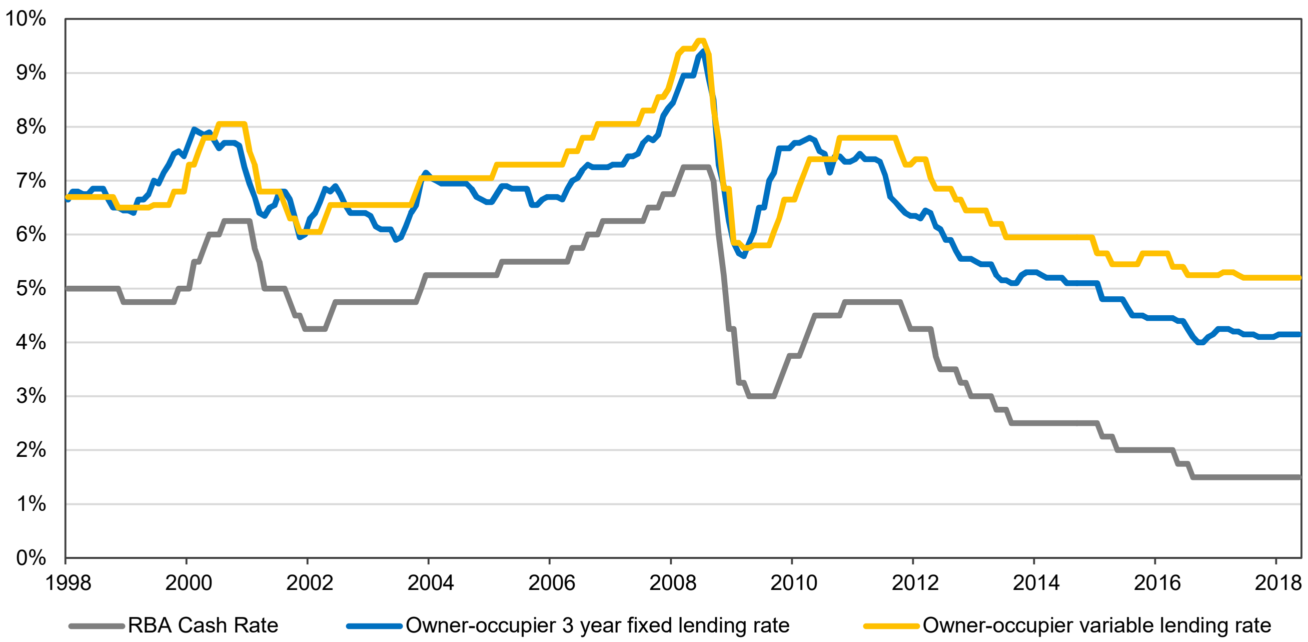
Private Sector Credit - Percentage of Total



Source: Reserve Bank of Australia, Auscap

Part of the equation has been falling borrowing costs. As interest rates fall, households can afford to borrow more money with the same dollar of income. Whether this is a sensible strategy might be a question for debate. In recent years APRA has started to insist that lenders use a minimum borrower interest rate assumption of 7% to assess a borrower's capacity. This is recognising that interest rates are unlikely to stay low forever, and that housing loans are typically written over a 25 or 30 year period. Ensuring that households can afford their loans under a higher interest rate scenario is logical and sensible.

Australian Borrowing Costs



Source: Reserve Bank of Australia, Auscap

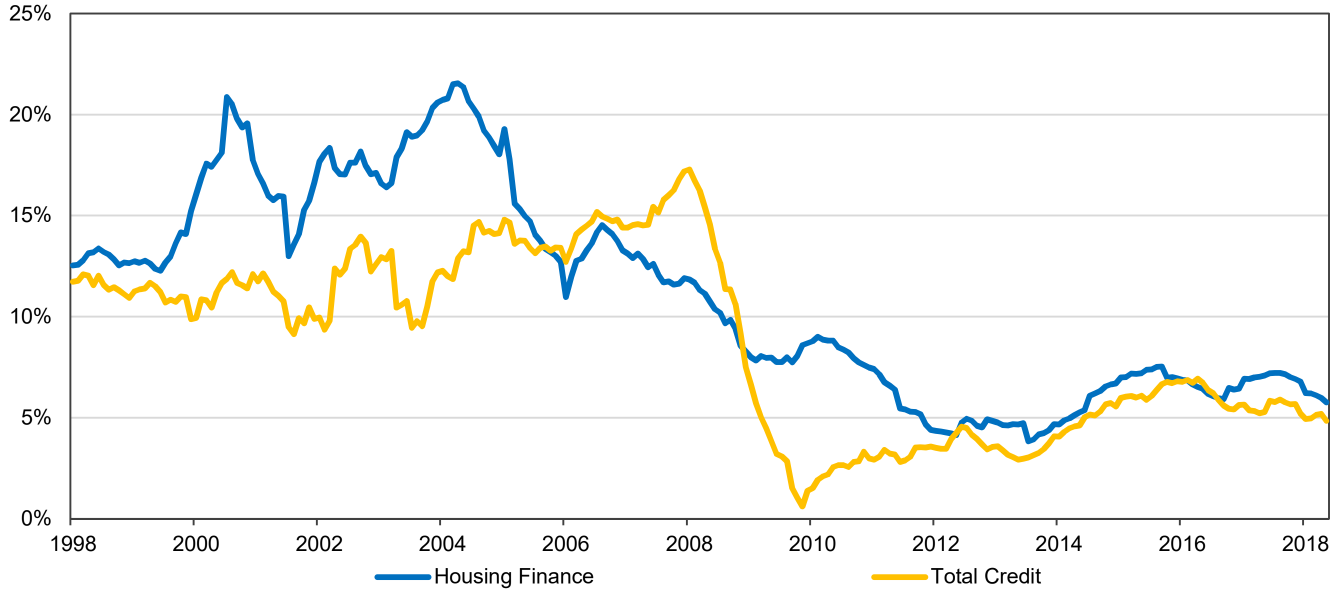
The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) appears to have uncovered another reason explaining why and how leverage has been ballooning. The availability of credit has been growing partly due to the widespread understating of household expenses and a corresponding lack of due diligence by lenders to investigate the facts. An over-reliance on the Household Expenditure Measure (HEM), an index designed to put a *floor* on claims of low living expenses, was being used by a large number of loan applicants and lenders as the estimate for actual annual non-housing related living expenses. When applied, this index has been an unrealistically low approximation of household expenditure for the majority of households.

We suspect ensuring appropriate household expenditure due diligence is conducted by lenders will be an outcome of the Royal Commission. As Wayne Byers, Chairman of APRA, stated in a speech to the Australian Business Economists, "*Under ASIC's responsible lending obligations, banks are required to make reasonable inquiries into borrowers' living expenses, and APRA's own prudential practice guide is clear that benchmarks shouldn't be relied on to proxy expenses. Benchmarks can be helpful in providing a prudent floor where borrower declared expenses appear low, but should not be a replacement for making reasonable inquiries*." The major banks appear to have already adopted more stringent measures to verify household expenditure. More detailed inquiries are now being done. Formal due diligence on bank account and credit card statements could be an outcome. Positive comprehensive credit reporting will undoubtedly give lenders a greater ability to assess a borrower's financial position.

How this affects leverage ratios and the creation of household credit is unclear. It is a possibility that household leverage ratios are peaking. This is significant, because increasing leverage has clearly been a partial driver of house price growth over recent years. If deleveraging were to take place, this credit contraction would reduce property price growth. The outcome of the Royal Commission, APRA's multi-year focus on ensuring prudent lending standards and the banks' adoption of more rigid standards is not yet clear in the data. As Wayne Byers commented "*the changes in lending practices to date do not seem to have had an obvious impact on housing credit flows in aggregate*". But perhaps this is no surprise. Living expenses featured in the Royal Commission in March 2018. Our enquiries with a number of lenders suggest that living expenses came into greater focus around this time. So will a sustained focus on living expenses be the straw that breaks the camel's back?

There is a lot of mixed reporting in relation to credit growth. Many comment on the size of domestic credit in aggregate. This data relates to the stock of total credit in an economy. It is last year's aggregate credit plus new credit created less any credit extinguished.

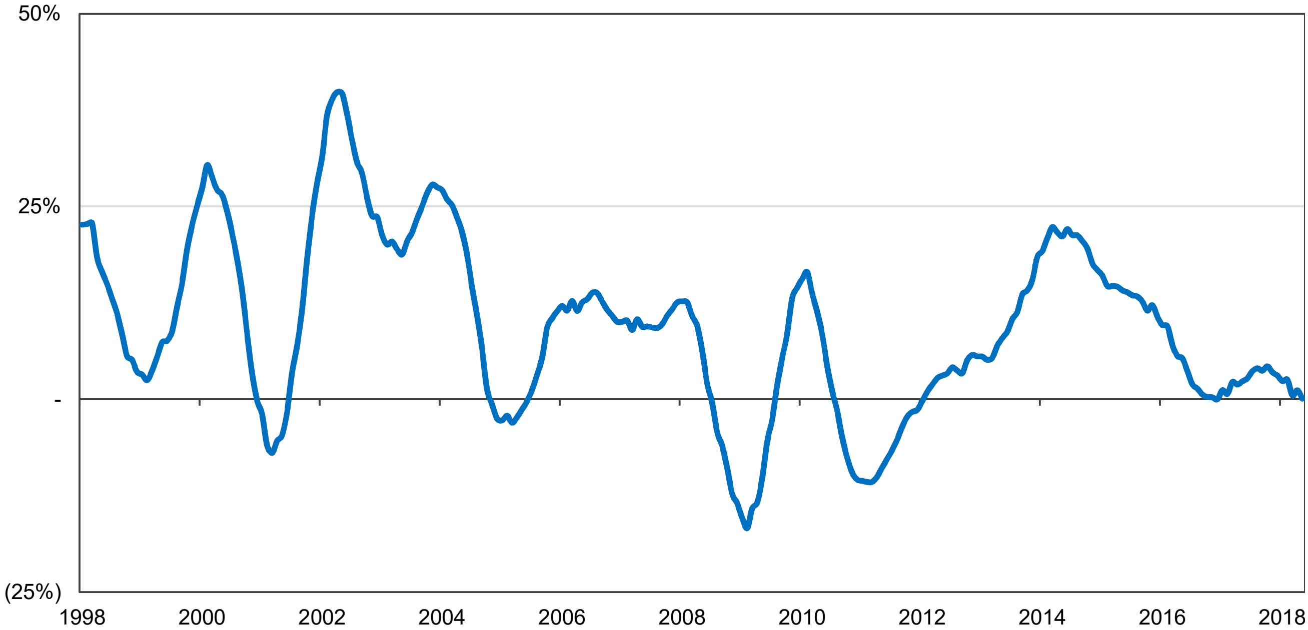
Credit Growth (Year On Year Change In Credit Stock)



Source: Reserve Bank of Australia, Auscap

It is our view that this is a lagging indicator for what is happening in the economy, which operates more on the flow of credit. That is, how much new credit is being created this year versus how much was created last year. The largest component of credit is housing related credit.

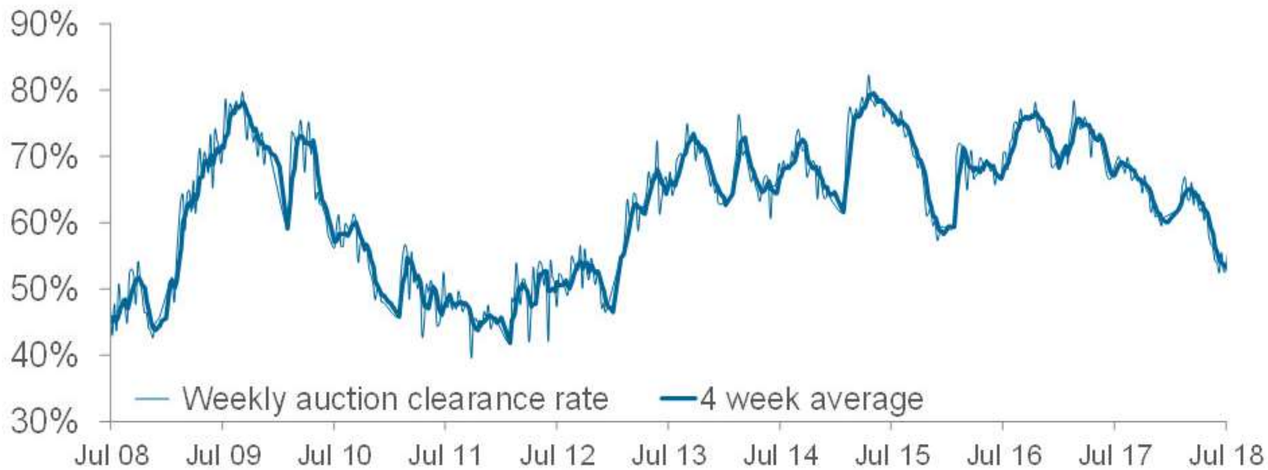
Housing Credit Flow Growth (Year On Year Change In Credit Flow)



Source: Reserve Bank of Australia, Auscap

The most recent May 2018 data point suggests new housing credit growth is weak, coming in at just +0.08% on an annualised basis. It is worth noting that the May 2018 data point reflects settlement data. The actual exchange of properties that has led to this data most likely occurred six to eight weeks prior. This data potentially predates any changes made by lenders following the Royal Commission's focus on household expense verification. If borrowers are now finding it more difficult to obtain credit, this might not immediately present itself in the data. However, we suspect there are a few leading indicators. One such indicator might be auction clearance rates. It would be understandable that vendors have price expectations based on comparable sales made six to twelve months ago. But if a borrower's capacity has been reduced, there might be a noticeable gap between a buyer's ability to pay and a vendor's expectation on price. It is interesting to observe that clearance rates around the country have recently fallen significantly.

Weekly Australian Auction Clearance Rate, Combined Capital Cities



Source: Corelogic

If lower clearance rates and listing volumes are symptomatic of falling housing credit growth, this should become apparent in the data over the coming months. It should be noted that the level of housing credit growth has important implications for the domestic economy. Has Australia become overly reliant on the creation of housing credit and increased household leverage to fuel economic growth? Only time will tell. In the interim we will continue to analyse the data carefully. It might provide both long and short opportunities for the Auscap Fund in the near term.

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