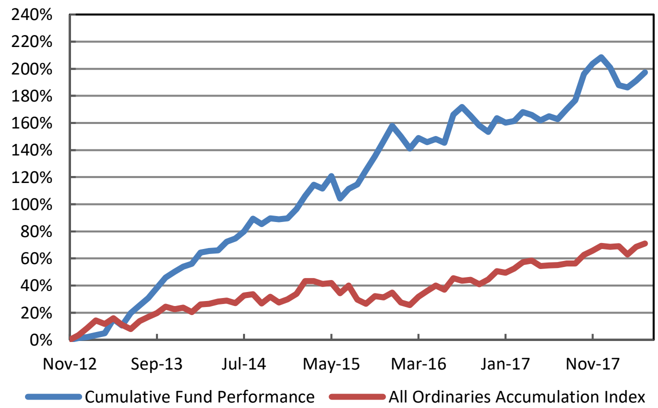
Auscap Long Short Australian Equities Fund Newsletter – June 2018

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 examine the increase in leverage in China over the last decade and question whether associated risks are being priced appropriately.

Fund Performance

The Fund returned 2.11% net of fees during May 2018. This compares with the All Ordinaries Accumulation Index return of 1.40%. Average gross capital employed by the Fund was 88.1% long and 27.4% short. Average net exposure over the month was 60.7%. Over the month the Fund had on average 26 long positions and 15 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
May 2018	2.11%	1.40%
Financial Year to date	12.20%	10.47%
Calendar Year to date	(3.61%)	1.06%
Since inception	197.36%	71.04%

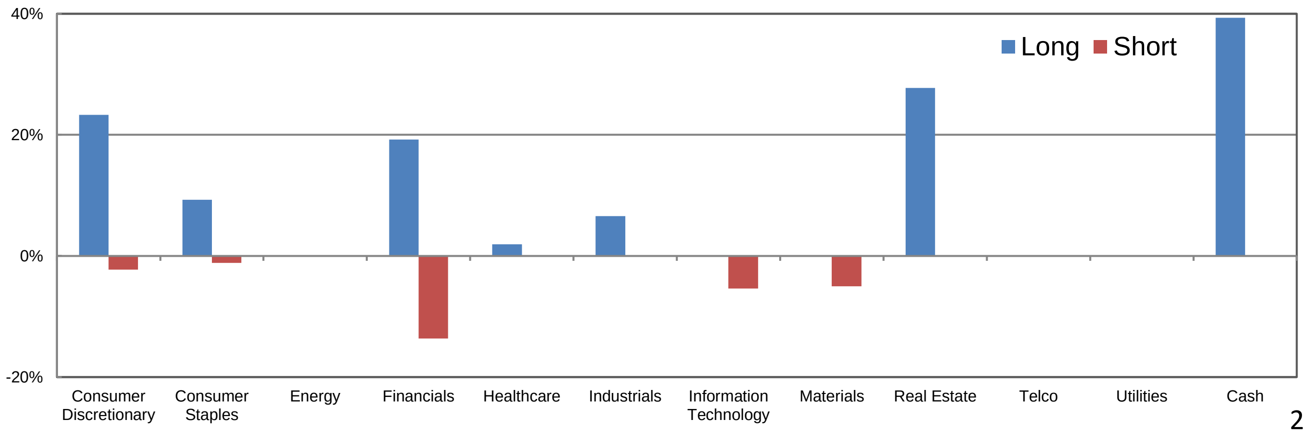
Fund Exposure

May 2018 Average	% NAV	Positions
Gross Long	88.1%	26
Gross Short	27.4%	15
Gross Total	115.5%	41
Net / Beta Adjusted Net	60.7%	36.5%

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		12.20

Sector Exposure - May 2018

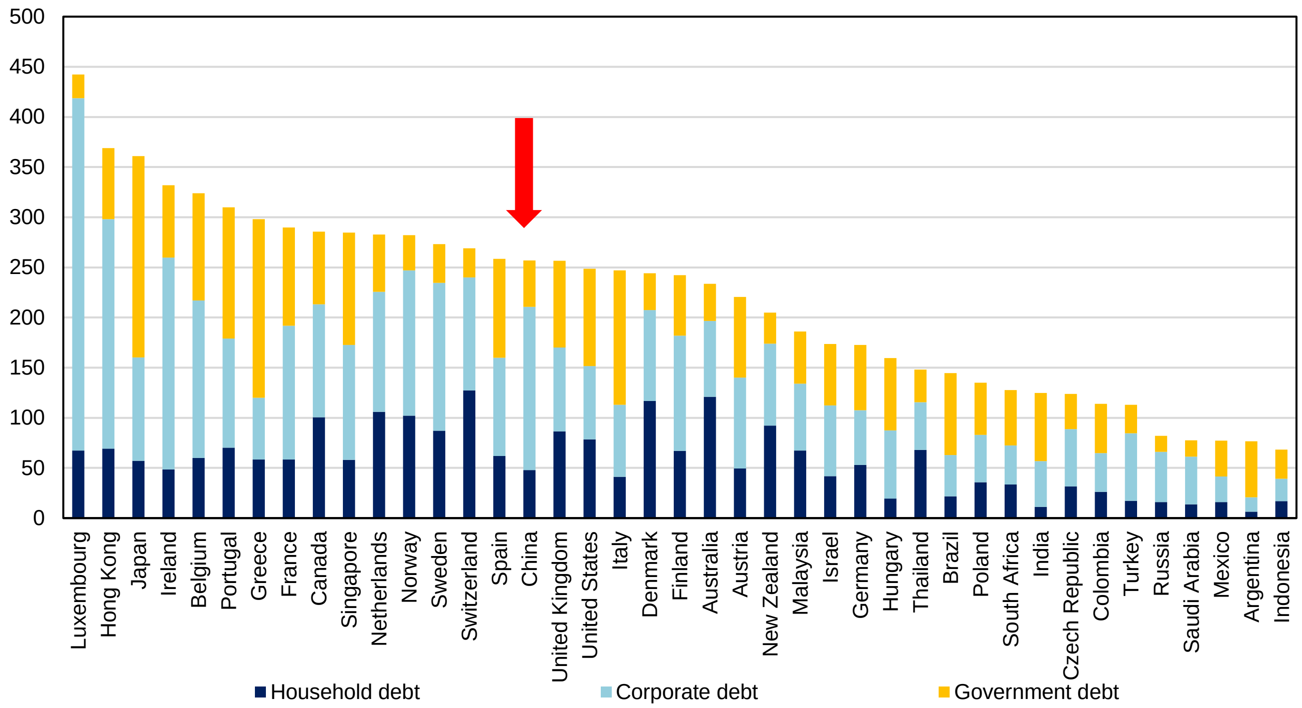


Are Risks Arising From China's Increasing Leverage Being Appropriately Priced?

At any given time, risks can be elevated in particular parts of the market. If these risks are being highlighted and focused on by investors, then the affected stocks may represent opportunities for the astute investor. At other times particular risks are elevated but not appropriately priced. This can be the result of any number of factors. Quite often if a risk has been elevated for some time, but has not yet presented itself in terms of producing negative consequences, the risk is gradually ignored by markets. And so the risk no longer becomes adequately priced and actually poses a far greater risk to investors than when the risk was in focus.

There is some irony in the fact that when risk is most obvious to all, it is typically priced into stock prices appropriately, and when risk is not obvious or infrequently discussed, that the risk to capital can be very real. In March the Reserve Bank of Australia released a Bulletin titled *Non-bank Financing in China* in which they discussed the risks to financial stability from the increasingly complex shadow banking activity within China. Aggregate leverage in China today is higher, as a percentage of GDP, than the United States of America, the United Kingdom, Australia and many other developed countries. It is worth noting that this is despite the fact that many of these developed countries are currently also experiencing record levels of aggregate debt across the household, corporate and/or government sectors.

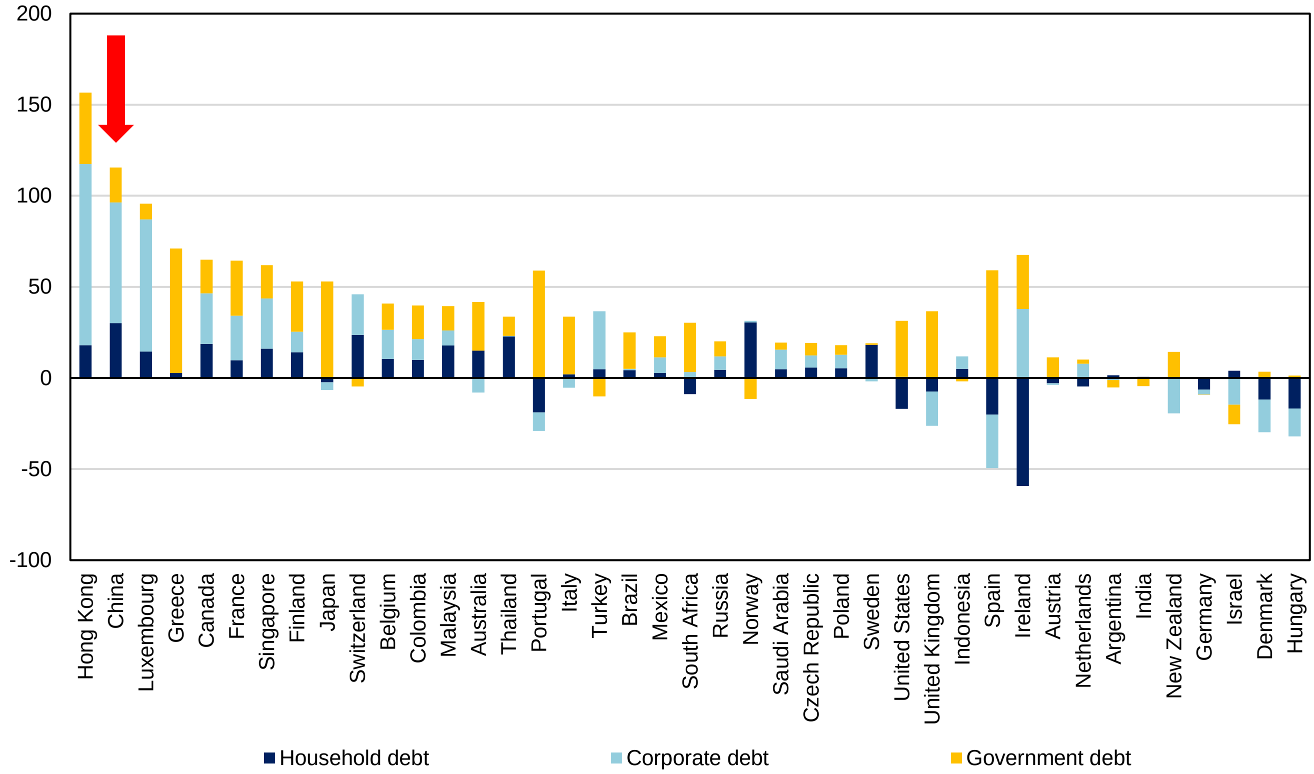
Total Non-Financial Sector Debt (% of GDP)



Source: Bank of International Settlements, Auscap

What is perhaps more concerning is that China's leverage has increased most significantly over the last decade, as shown in the chart on the following page. A rapid increase in leverage can lead to vulnerabilities within an economy. As Alan Greenspan noted in a speech as US Federal Reserve Chairman in 1998, *"high leverage is often a symptom of excessive risk-taking that leaves financial systems and economies vulnerable to a loss of confidence… both financial and nonfinancial businesses can employ high leverage to mask inadequate underlying profitability and otherwise have inadequate capital cushions to match their volatile environments."* China's increase in leverage over the last decade has seen the country add more than 100% to its debt to GDP ratio, easily the most significant increase in leverage amongst the major global economies.

Change in Total Non-Financial Sector Debt (% of GDP - 2008 to 2017)

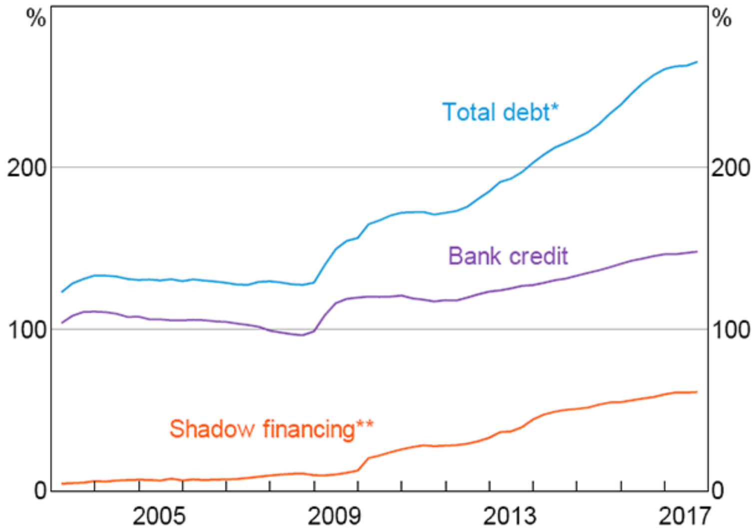


Source: Bank of International Settlements, Auscap

Historically, China's Government has had heavy involvement in the formal banking channels, including substantial ownership of the domestic banks. It has been a sensible assumption that, with a domestically funded and Government controlled banking sector, any confidence issues in relation to high levels of leverage could be managed. Interestingly, over recent years shadow financing has been a significant contributor to the growth in aggregate non-financial sector debt.

China – Non-financial Sector Debt

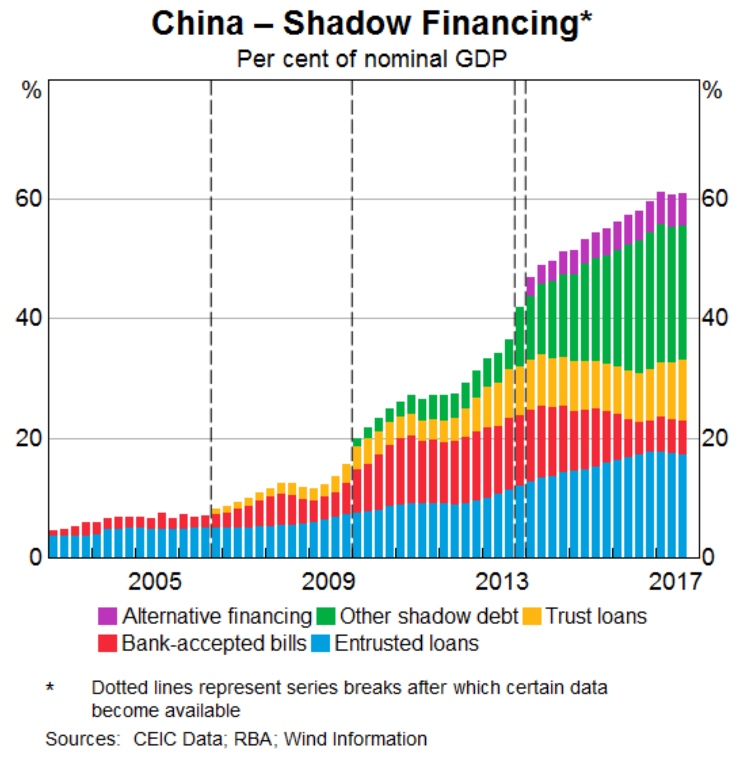
Per cent of nominal GDP



* Total debt is the sum of bank credit, shadow financing, and bond financing (both corporate and public)

** RBA estimate

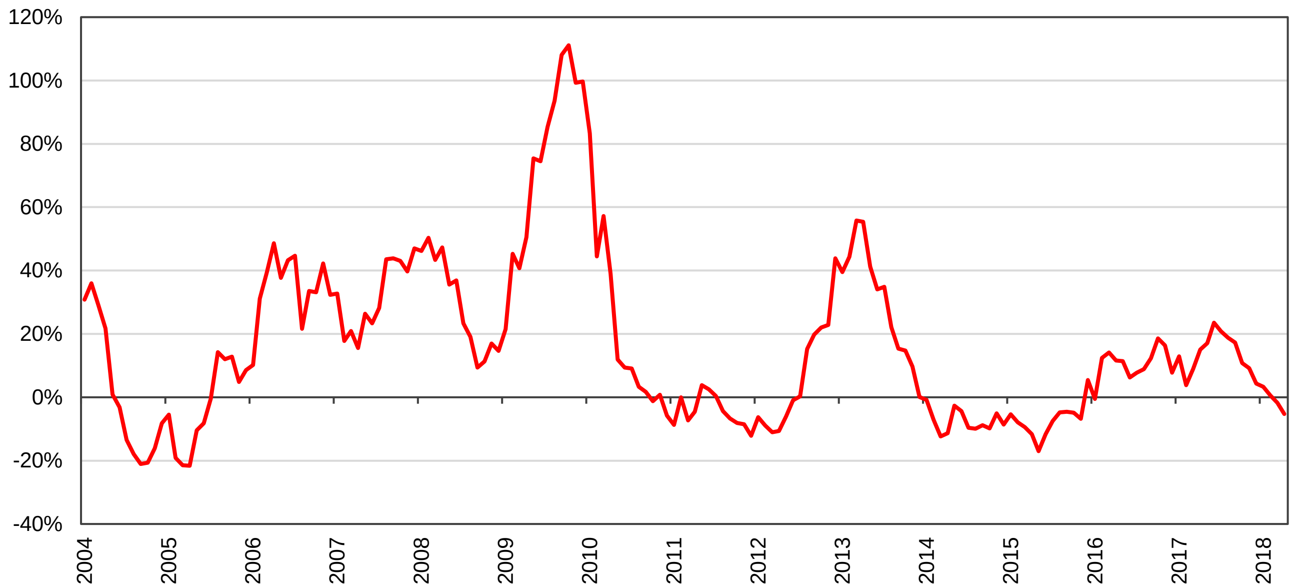
Sources: CEIC Data; RBA; Wind Information



This build up in shadow financing activity has been significant. While it is beyond this newsletter to delve into the different aspects of shadow financing, the risks around financial leverage are clearly rising. It is uncertain whether the Government would be able to control any fallout from defaults within the shadow financing system as it has been able to do within the formal banking system.

Clearly the debt burden is a focus for the Chinese Government. It has indicated that it is focused on reducing the country's unsustainable reliance on debt to grow its economy. Recent aggregate financing data, reflecting the outstanding amount of credit extended to businesses and consumers, witnessed a year on year decline after significant increases in 2016 and 2017. Whether this is the direct result of this Government focus on reducing domestic leverage is unclear.

China Aggregate Financing (Year on Year Change)



Source: Bloomberg, Auscap

A reduction in credit growth and tightening in liquidity within China potentially represents an elevated risk for equity assets exposed to Chinese growth in the near term. A reduction in leverage has potentially negative consequences for economic growth, which is anticipated to be lower than recent years. We remain cognisant of these risks and Australia's economic exposure to the continued growth of China's economy. It is possible that these risks are not currently being suitably priced into the domestic equities that could be directly affected by any deleveraging or reduction in liquidity that might take place over the next few years.

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