Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – May 2018

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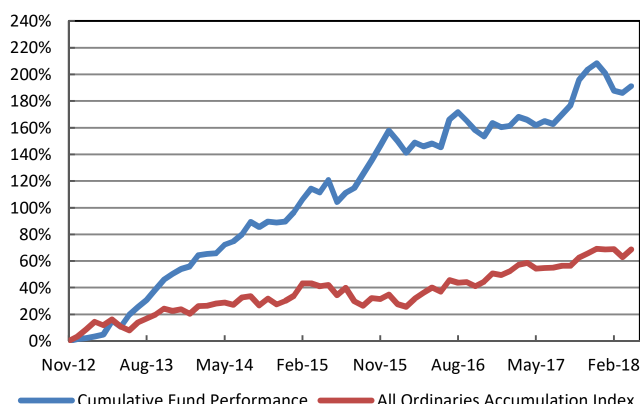
Welcome

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 take a different look at the assumptions underpinning the broad market view that investors should avoid the "bond-like" real estate investment trusts.

Fund Performance

The Fund returned 1.75% net of fees during April 2018. This compares with the All Ordinaries Accumulation Index return of 3.49%. Average gross capital employed by the Fund was 104.0% long and 15.7% short. Average net exposure over the month was 88.3%. Over the month the Fund had on average 27 long positions and 11 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
April 2018	1.75%	3.49%
Financial Year to date	9.96%	8.94%
Calendar Year to date	(5.60%)	(0.33%)
Since inception	191.22%	68.68%

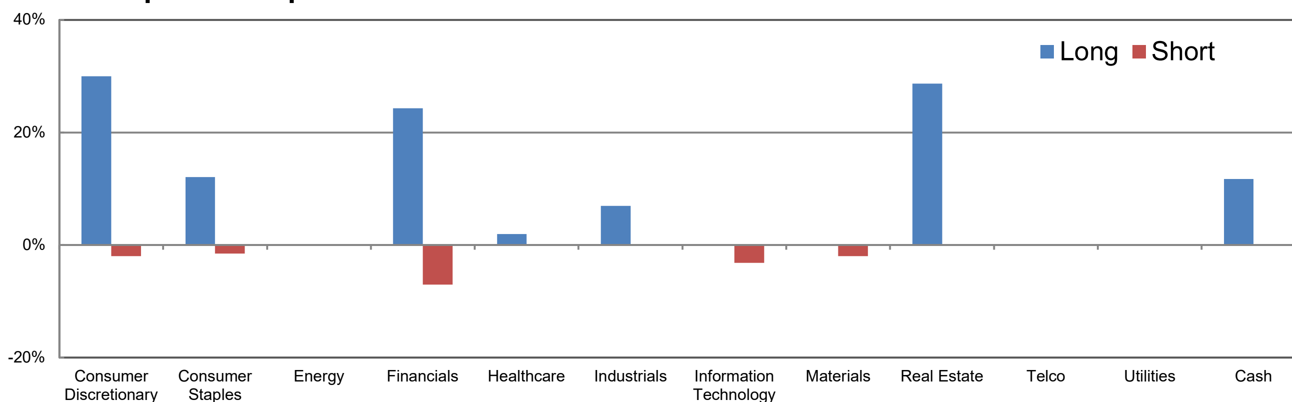
Fund Exposure

April 2018 Average	% NAV	Positions
Gross Long	104.0%	27
Gross Short	15.7%	11
Gross Total	119.7%	38
Net / Beta Adjusted Net	88.3%	62.8%

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			9.96

Sector Exposure - April 2018



Are REITs The Ugly Duckling Of The Stockmarket?

As portfolio managers we are always wary when future events or potential outcomes are treated as certainties by the majority of investors. With investing there are no certainties, only probabilities. At the extremes the market often assumes that an event will occur (or will continue to occur), the consequence of this being that assets that are negatively impacted by the future event are disregarded and sold off to levels that can imply decent returns even if that event does occur. Such positions become very profitable if the event that is supposed to occur does not. Markets have a habit of being unpredictable at precisely the moment that everyone is sitting on the same side of the boat. At the extremes, the majority have not infrequently been wrong.

While potentially not extreme in nature, there are a few general assumptions being made by investors in relation to the real estate investment trusts (REITs) that would deem them unworthy of consideration for investment.

The assumptions, as far as we can tell, are some variation of the following logic:

1. Global interest rates are rising, as indicated by rising bond yields (this is an argument premised on one or more factors including future assumptions around rising inflation, falling money supply, growing economic growth and/or a normalisation of interest rates);

2. Therefore, global bond yields are going to continue to rise;

3. Therefore, Australian Government bond yields will also rise;

4. Therefore, “bond-like” equities will need to offer higher distribution yields to attract investors, causing their stock prices to fall (which increases their yield);

5. Therefore, investors should not own “bond-like” equities, including REITs, utilities and infrastructure stocks.

In this newsletter we make a few brief comments on these assumptions, in particular the ones that are premised on causality, the assumption that when one outcome occurs this will immediately lead to a second outcome.

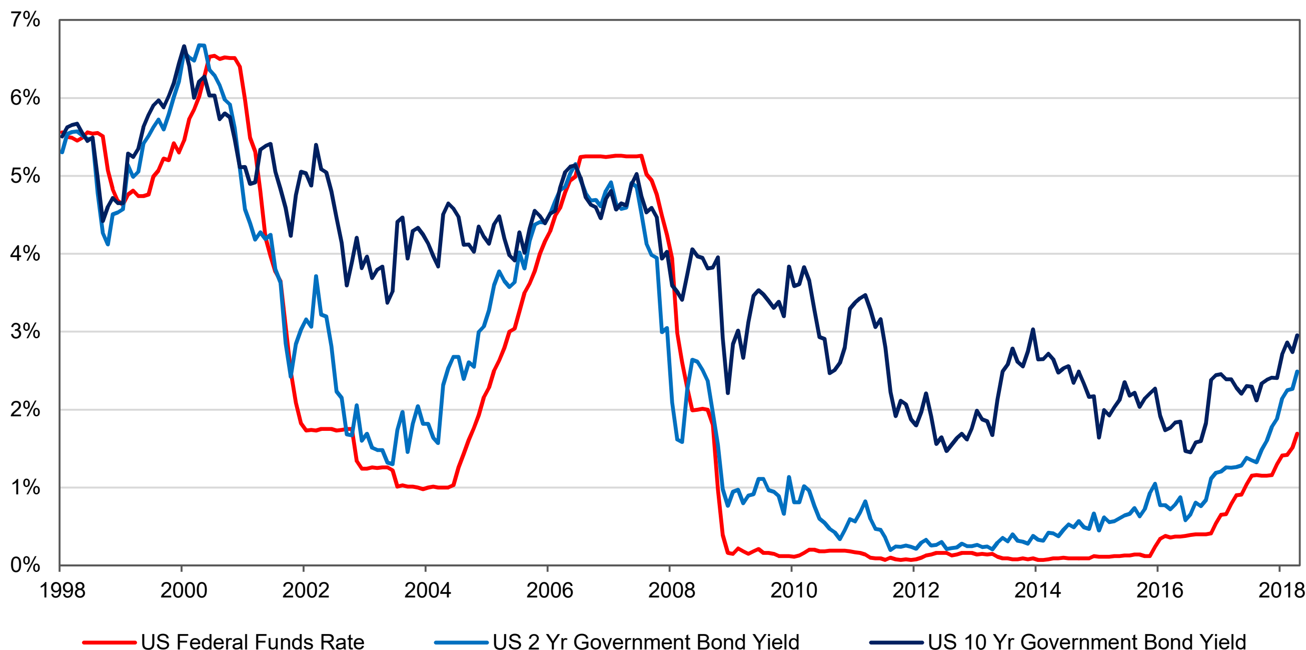
Assumption 1: Global interest rates are rising

Global interest rates may be heading higher for all of the reasons quoted regularly in the financial press. This expectation is currently factored into global markets. It is the reason that short term US Government Bond yields are higher than the US Federal Funds Target Rate. This can be seen in the chart on the following page. Currently the spread between the US Federal Funds Target Rate and a US 2 Year Government Bond is over 0.8%, implying that the market is currently factoring in an increase in the Target Rate of over 0.8% over the next two years.

Assumption 2: Global bond yields are therefore going to continue to rise

Government bonds are already pricing in a reasonable increase in interest rates in the US over the next few years given the current difference between the Federal Funds Rate and the yield on a US 2 Year Government Bond. While a continued rise might be the most likely outcome, it is not a certainty. There are many reasons which form the basis of current interest rate expectations in relation to GDP growth, inflation and monetary policy response and which explain this spread. However, in an efficient market the collective knowledge and expectations of all investors are already factored into bond prices.

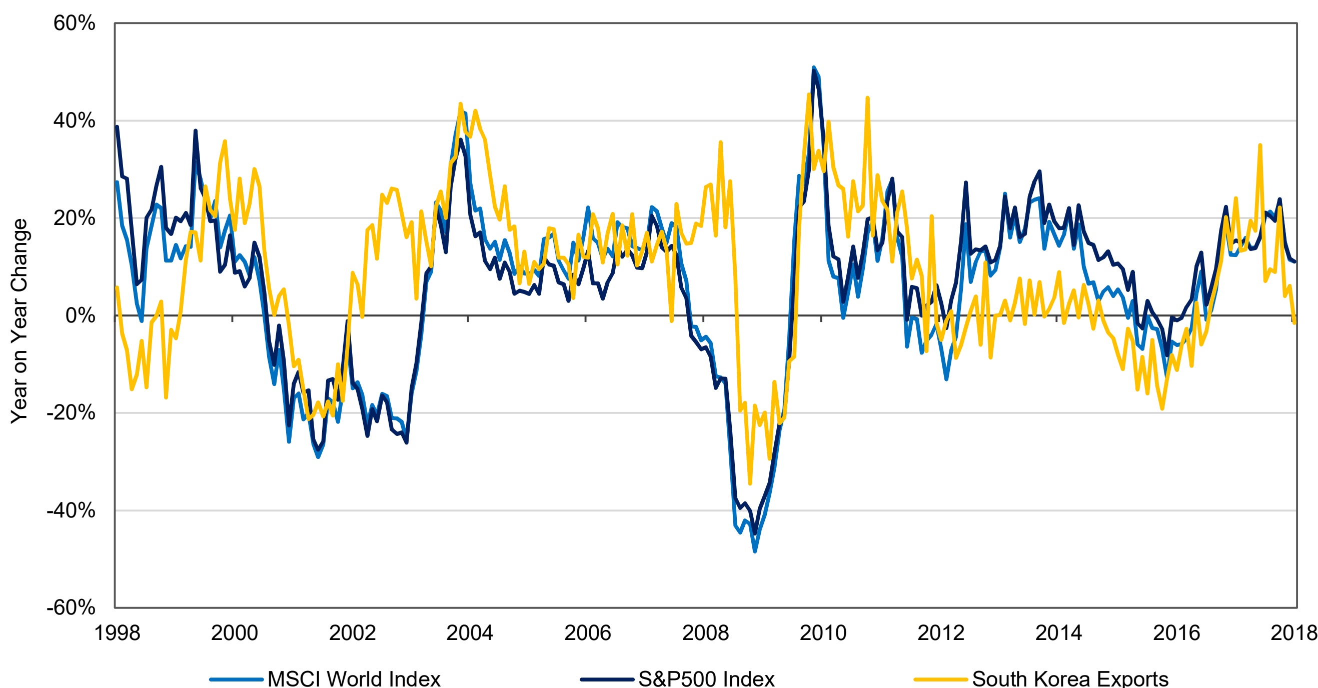
US Cash and Government Bond Rates



Source: Bloomberg, Auscap

A change in these expectations could be positive or negative from this point forward. A significant unexpected slowdown in growth for one or more of the world's major economies could change future expectations for global growth considerably. Yet some recent economic signals have been mixed. South Korea is often considered a bellwether for the health of the global economy due to the nature and extent of its export industry. It is heavily reliant on exports to drive its economy, with exports constituting over 34% of GDP. Its main exports are electrical and other machinery, vehicles, large ships, steel products and plastics. In April South Korea recorded a decline in year on year exports for the first time since late 2016.

Change in Major Global Indices vs South Korean Exports (YoY)



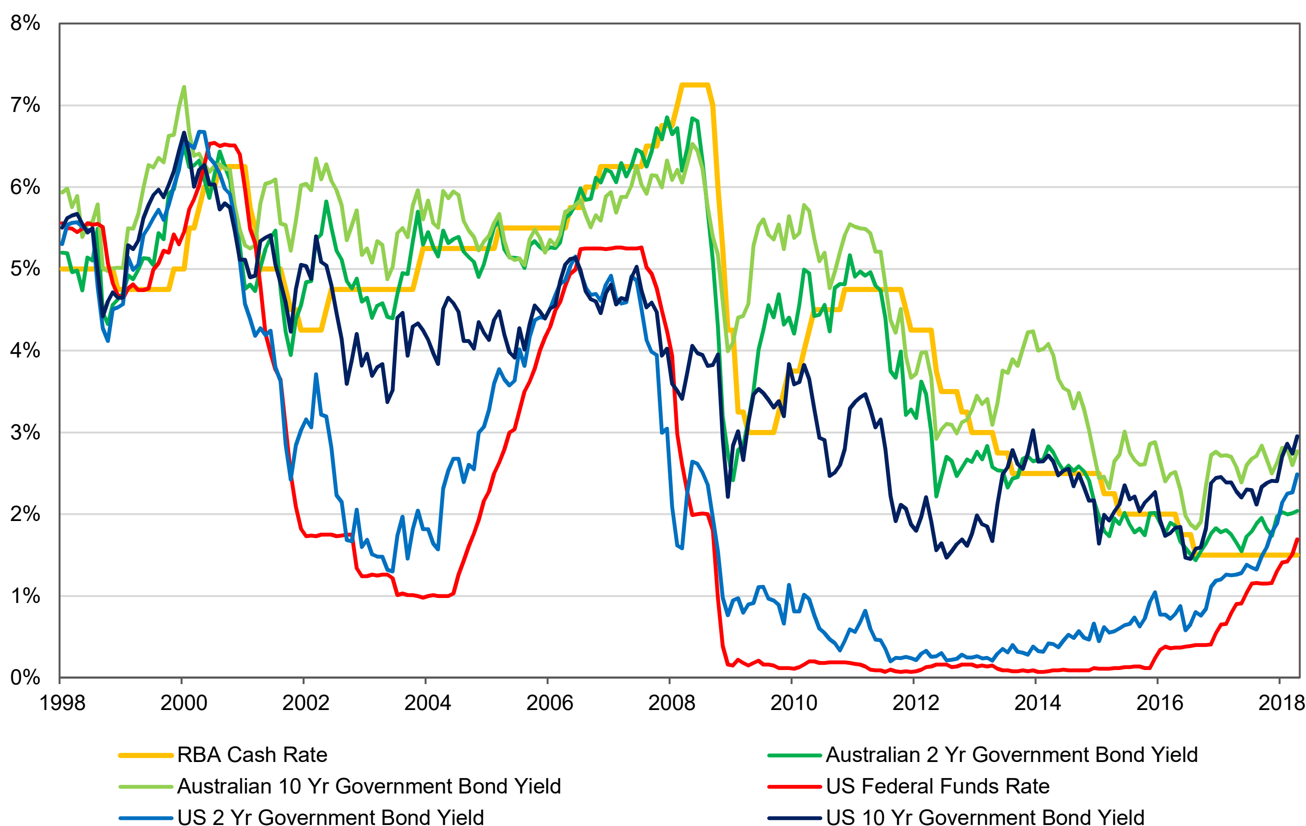
Source: Bloomberg, Auscap

Assumption 3: Australian Government bond yields will also rise

Once the assumption that US Government Bond yields are heading higher is in place, a derivative of this is that Australian Government Bond yields will follow. While this has historically been the case, there are periods when this logic fails to hold true. As shown in the chart below, US Government Bond yields have recently surpassed Australian Government Bond yields. The US Federal Funds Target Rate (1.75%) now exceeds the RBA Target Cash Rate (1.50%). Given the respective outlook for the two economies in the near term, this is unsurprising. A continued divergence cannot be ruled out.

While it is not within the ambit of this newsletter to go into the reasons behind the potential divergence in growth between the Australian and US economies, it is not a fait accompli that Australian Government Bond yields will rise simply because of a move higher in US Government Bond yields, if in fact that eventuates. It might be *likely*, but it is not a certainty.

Australian vs US Cash and Government Bond Rates



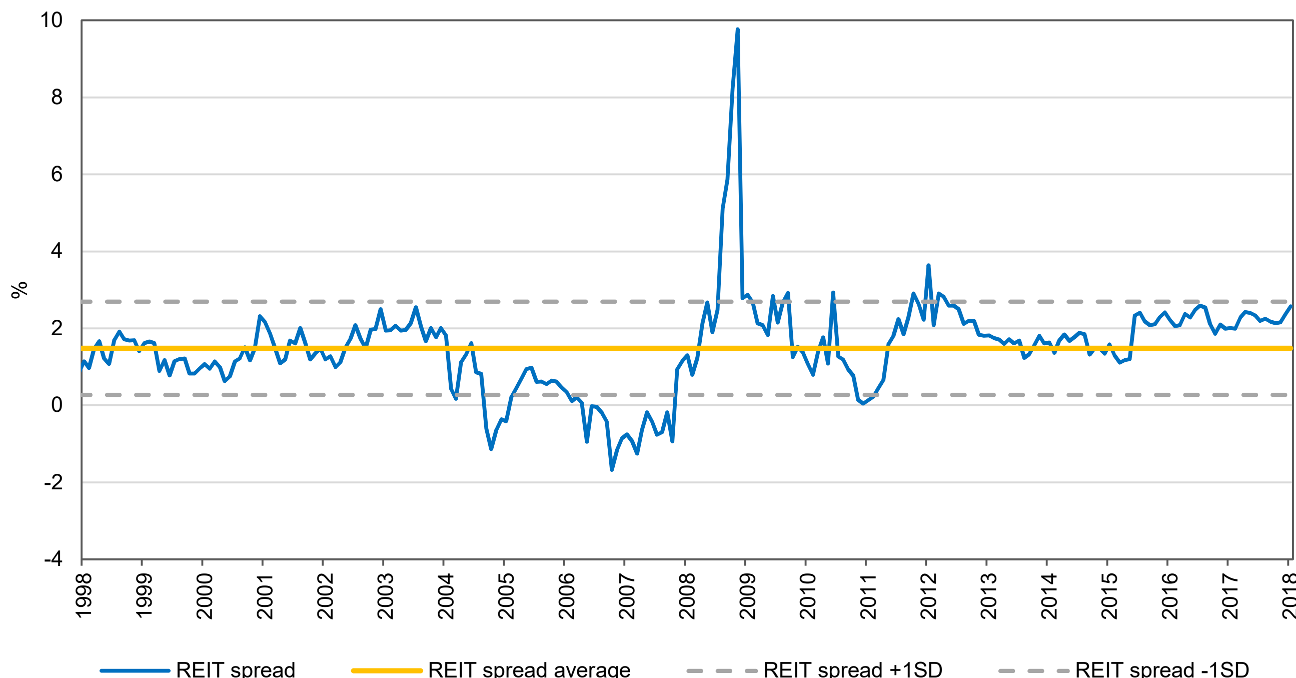
Source: Bloomberg, Auscap

Assumption 4: Bond like equities will need to offer higher distribution yields to attract investors, causing their stock prices to fall

The fourth assumption is that if Australian Government Bond yields rise, then stocks that are so-called "bond-proxies", companies that are largely valued on the basis of an implied dividend yield, will fall in value. Stocks that typically fall into this camp include REITs, utilities and infrastructure companies. If investors demand an increase in the yield that these stocks offer, then this assumption will hold true. But there is an implicit assumption being made, that the yield differential or spread between Australian Government Bonds and Australian Real Estate Trusts remains relatively constant over time. In fact the relationship between the yield on the bond instruments and the bond proxies has varied considerably over time.

Currently the spread between the yield on the 10 Year Australian Government Bond and the Australian REIT Index is almost one standard deviation above the mean. In other words, the yield on the 10 Year Australian Government Bond could rise another 1.2% and if the REITs held their current value, this spread would only move back to its long term average.

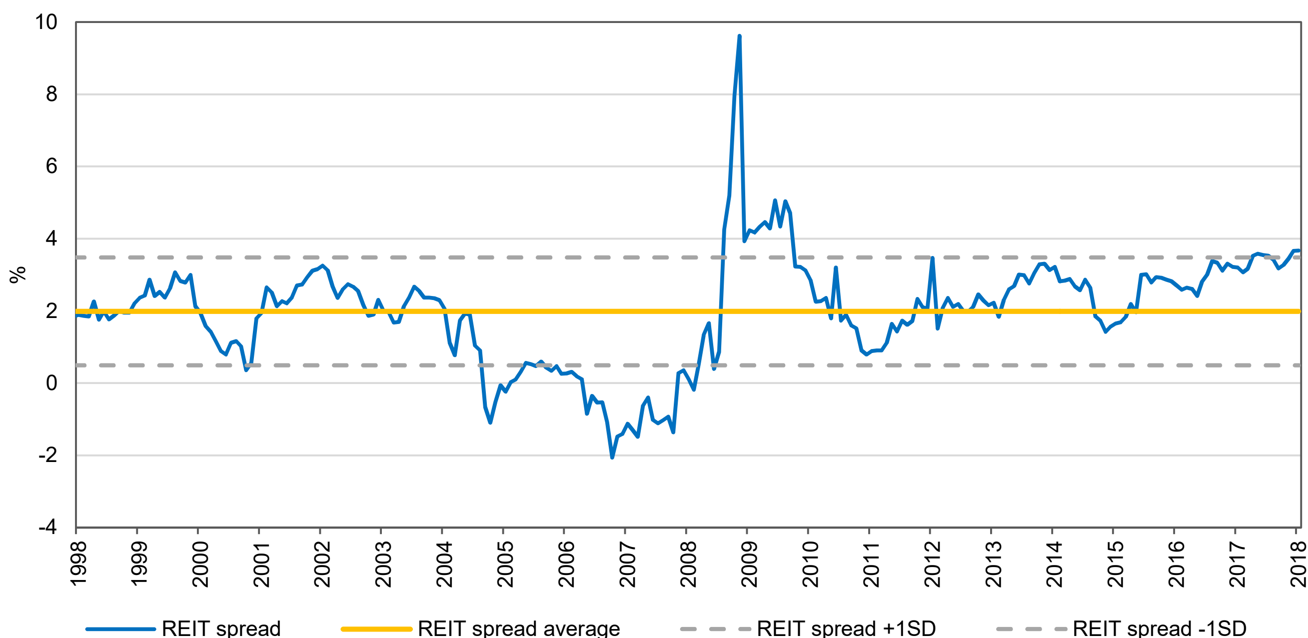
REIT Dividend Yield Spread Over 10 Year Australian Government Bond Rate



Source: Bloomberg, Auscap

The yield spread between the REITs and the RBA Cash Rate is even wider. The RBA Cash Rate could increase another 1.5% and if the REITs held their value the spread would move back to its 20 year average.

REIT Dividend Yield Spread Over RBA Cash Rate



Source: Bloomberg, Auscap

Assumption 5: Investors should not own "bond-like" equities

Even if all of these assumptions do hold, should we conclude that investors should forego ownership of all "bond-like" equities? Certainly investors should be aware of the risks and correlations, and factor in the possibility of rising interest rates and the potential implications into their thinking. But in situations where negative assumptions are being made by many, causing investors to flee a sector in large numbers, the proverbial baby can be thrown out with the bathwater. In such circumstances we spend as much time as possible analysing the sector for company specific opportunities.

Indeed, we currently hold a portfolio of REITs with the following characteristics:

	Auscap REITs	**RBA Cash Rate**	**10yr Australian Government Bond**
Premium/(Discount) to NTA	2.3%	0.0%	0.0%
Yield	6.7%	1.5%	2.8%
FY19 Forecast Earnings Growth	7.6%	0.0%	0.0%
Gearing	26.5%	0.0%	0.0%
WALE	6.0 years	-	10.0 years

Source: Iress, Bloomberg, Auscap

We think the standalone characteristics of our REITs are compelling from an absolute return perspective given the business risks involved. Our REIT investments offer a 6.7% yield and earnings growth of 7.6%, compared to the 1.5% of the RBA Cash Rate and 2.8% yield offered by the 10 Year Australian Government Bond, both of which provide no growth in yield over time. Many of these REITs have funds management and/or development businesses attached to the trust assets that are implicitly being valued at close to zero given these companies only trade at a small combined premium to NTA. These are terrific cash generating businesses, with lower than market business risk attributes and strong management teams that are active in optimising their suite of assets. They are businesses that we understand, that we think represent compelling value for our investors and that we intend to hold for a long time.

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