Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – October 2018

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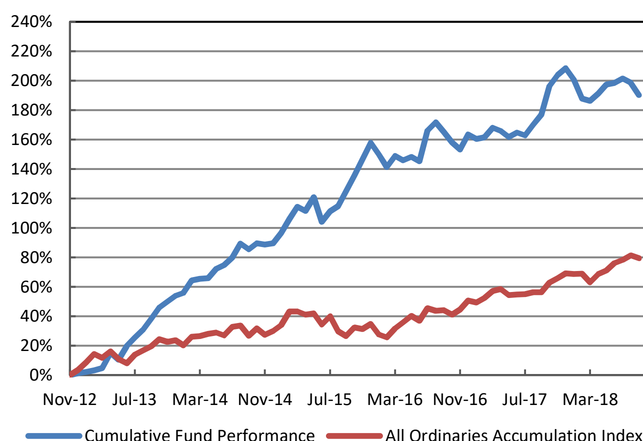
Welcome

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. In this edition we discuss agency risk, the conflict facing management teams between acting in their own interests and those of their shareholders.

Fund Performance

The Fund returned negative 2.85% net of fees during September 2018. This compares with the All Ordinaries Accumulation Index return of negative 1.06%. Average gross capital employed by the Fund was 91.2% long and 5.9% short. Average net exposure over the month was 85.3%. Over the month the Fund had on average 32 long positions and 5 short positions. The Fund's biggest stock exposures at month end were spread across the communication services, consumer, financials and real estate sectors.



Fund Returns

Period	Auscap	All Ords
September 2018	(2.85%)	(1.06%)
Financial Year to date	(2.83%)	1.86%
Calendar Year to date	(5.97%)	5.98%
Since inception	190.10%	79.36%

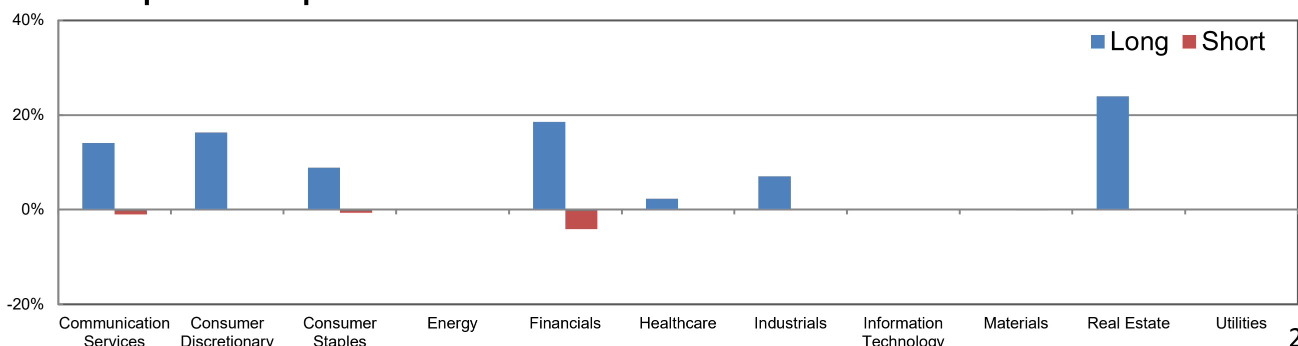
Fund Exposure

September 2018 Average	% NAV	Positions
Gross Long	91.2%	32
Gross Short	5.9%	5
Gross Total	97.1%	37
Net / Beta Adjusted Net	85.3%	61.8%

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
FY19	1.02	(0.99)	(2.85)										(2.83)

Sector Exposure - September 2018



The Shareholder Conundrum – Agency Risk

One of the biggest investment risks we spend time considering is agency risk. The agency dilemma is the risk that management of a company, consciously or subconsciously, uses its position to benefit itself rather than the shareholder base. Management may make decisions that are clearly in their interests but are not in the best interests of the owners of the company. This is often because management are not naturally aligned with shareholders unless they are substantial shareholders.

There are many obvious examples of agency risk:

- Senior management paying themselves disproportionately to the earnings of the business and their own performance;
- Management increasing corporate expenses including significant employee perks;
- Management focusing on growing the size of the business, rather than its profitability. This is often referred to as “empire building”;
- Management hiring and continuing to employ friends and relatives, irrespective of competence and performance; and
- In extreme cases, management or employees stealing directly from the company.

There are also many less obvious examples of agency risk:

- Management taking on risky projects that exceed the risk tolerance established by the board and shareholders because they have the possibility of increasing short term earnings to hit performance targets;
- Management making investment decisions that might maximise the short term earnings and/or share price performance to realise incentive payments, even if those investment decisions are not in the long term interests of shareholders;
- Management adopting aggressive accounting practices that overstate the true financial position of the company;
- Management “kitchen sinking” results early in their tenure. This involves taking excessive provisions and write-downs in early years to demonstrate improved performance and make earnings targets easier to reach in later years;
- Management increasing leverage within a business to increase earnings per share; and
- Management making decisions on mergers and/or acquisitions either as the target or the acquirer that result in substantial personal benefits when the benefit for shareholders is far less apparent.

Many of these latter examples are instances of “heads I win, tails you lose”. If any of the major risks associated with such activity do not present themselves in the short term, management compensation (and praise!) increases. If the risks do appear, typically it is the shareholders that wear most of the cost. In the last newsletter we discussed the myriad of ESG issues that are emerging across corporate Australia at present. It could be argued that many of these problems are caused by incentive structures that have created agency risk.

The board is often meant to be the control mechanism preventing these clear examples of agency risk that result in a material cost to shareholders. However, it is often easier said than done for directors to monitor these issues. Any intelligent management team will have a myriad of reports and plentiful research supporting increased executive remuneration, corporate costs and the like. Hurdles for short and long term incentives are often complicated and driven by discussions with management. Suboptimal incentive structures are commonplace, providing justification for its perpetuance. Management often know the business substantially better than the directors and will propose incentive structures that are easier to reach and unfortunately, in many cases, manipulable. These issues are not easily navigated by directors with limited time and access to resources.

Directors themselves also have a potentially significant conflict. Many may have been nominated for their position by senior management. This creates a degree of loyalty. Often board positions are filled by professional directors. Raising sensitive issues around the board room may reduce the likelihood of a director being asked onto other boards in the future. For the professional director, this creates its own dilemma, particularly if the director is reliant on the income received from these board positions.

The agency problem is not insignificant for the professional investor. It can be an issue that takes up a considerable amount of our time. The risk of management proposing a major transaction that is not in the long term interests of shareholders but will elevate short term earnings or clearly have more benefit for management than shareholders presents itself often. The conflict between doing the right thing to generate long term shareholder wealth and maximising short term personal gain is substantial. Incentives drive behaviour. If the most tangible incentives are based on next year's earnings numbers, then management will be most focused on that result. Self-interest is an incredibly powerful driver of performance.

The answer to the agency problem is not a simple one. Boards can be led to believe that simply awarding management with stock and options over time will reduce the agency problem. While this may be the case if the stock award is justified, simply gifting an excessive number of shares and options to management will not promote the same alignment as is the case for management who have either built the business from the ground up or who have spent hard earned capital buying shares like every other investor.

Increasingly our focus is turning towards businesses where the agency risk is naturally lessened, typically where the CEO or board members have significant ownership either because the business is founder led or management have made significant on-market purchases. If the senior executives and directors have a substantial percentage of their wealth tied up in the company, the risk that they will act contrary to that interest, and hence yours as a shareholder, is greatly reduced. The likelihood that they will make sensible and intelligent long term decisions, particularly around investment, is also greatly enhanced. A sensible but small investment today that will not yield significant earnings benefits for shareholders for many years is likely to be of little interest to a CEO anticipating a 3 to 5 year tenure. But such an investment is absolutely in the interests of a major shareholder who expects to remain a major shareholder for the next 20 to 30 years.

We have always applied this mantra internally within Auscap. The portfolio managers are very substantially invested in the Fund and hold no outside interest in Australian listed equities. A large proportion of the personal wealth of all employees within Auscap is tied up in the Fund. We are naturally aligned. We will share in the periods of strong and weak performance, but most importantly we will always be focused on achieving the best outcomes for our investors over time.

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