Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – April 2018

Auscap Annual Roadshow 2018

Investing Outside The Square But Inside The Circle

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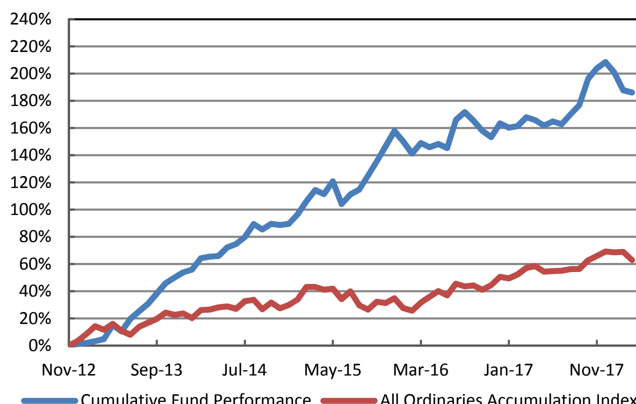
Welcome

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 passive versus active asset management debate and provide our thoughts on the current trend towards passive investing.

Fund Performance

The Fund returned negative 0.56% net of fees during March 2018. This compares with the All Ordinaries Accumulation Index return of negative 3.55%. Average gross capital employed by the Fund was 110.8% long and 8.5% short. Average net exposure over the month was 102.3%. Over the month the Fund had on average 26 long positions and 9 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
March 2018	(0.56%)	(3.55%)
Financial Year to date	8.07%	5.27%
Calendar Year to date	(7.22%)	(3.70%)
Since inception	186.28%	62.99%

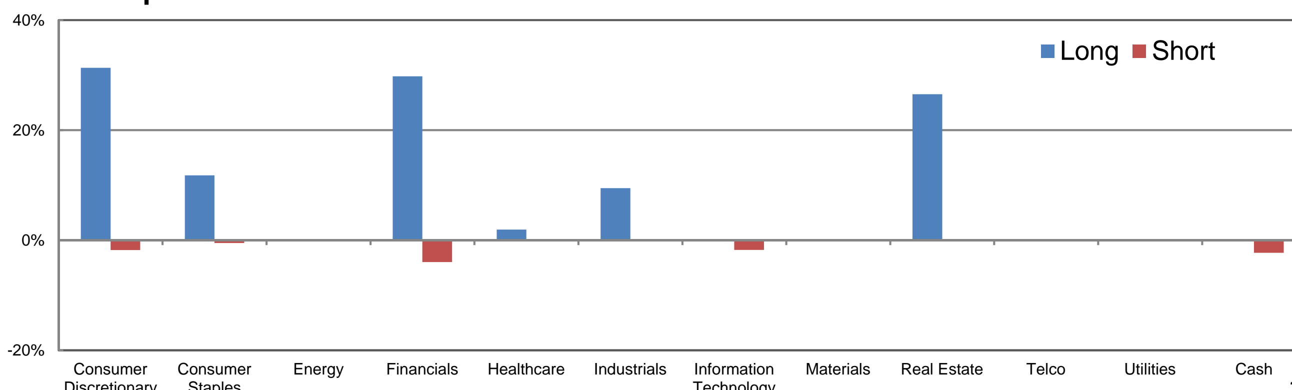
Fund Exposure

March 2018 Average	% NAV	Positions
Gross Long	110.8%	26
Gross Short	8.5%	9
Gross Total	119.3%	35
Net / Beta Adjusted Net	102.3%	71.3%

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)				8.07

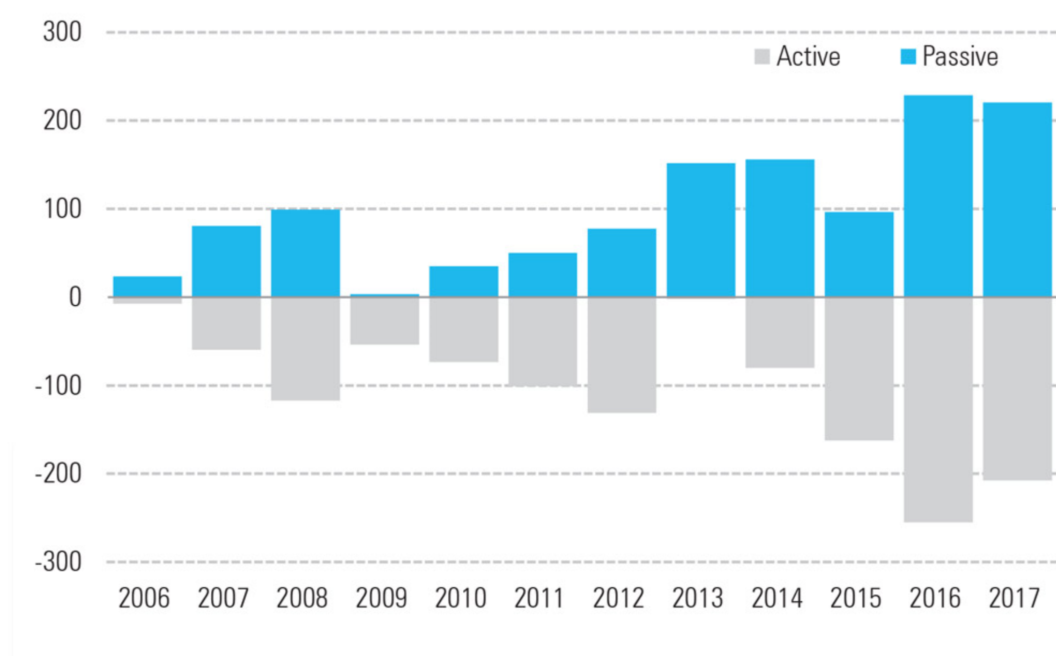
Sector Exposure - March 2018



Is There A Place For Both Passive And Active Asset Management?

There has been a considerable shift from active to passive asset management over the last decade, and nowhere has this trend been more prominent than in the US stockmarket. In US equities, hundreds of billions of dollars have been taken out of active asset management and reinvested passively into index products. Active managers in the US saw net redemptions of $207 billion in 2017 alone, which begs a couple of questions. Is there a place in the future for active asset management? And how comfortable are passive investors with the fact that no one is considering the merits of what they are investing in?

Passive asset management simply means more capital flowing into equities based on the relative size of the companies that constitute the index. Investments are weighted according to the relevant company's market capitalisation. As a high conviction, genuinely active asset manager, this concept is anathema to us. But that is not to say that it does not have a place in financial markets.



Source: Morningstar Direct Asset Flows

There are certain conditions where passive investing is predisposed to perform very well. In fact, in such conditions, passive managers are likely to outperform the average active manager. Passive asset management is extremely effective in periods that are favourable for equities (ie rising markets) where the very biggest companies in an index are delivering above average growth and attracting further capital.

Indeed for the US stockmarket we have just been through such a period. The S&P500, the predominant US equities benchmark, has delivered 15.8% including dividends per annum over the last five years. This is an exceptional period of strong performance. A large driver of this strong performance has been the outperformance of the technology related behemoths that had become, by 31 December 2017, the five largest companies in the US stockmarket. These companies are Apple, Alphabet (the parent company of Google), Amazon, Microsoft and Facebook.

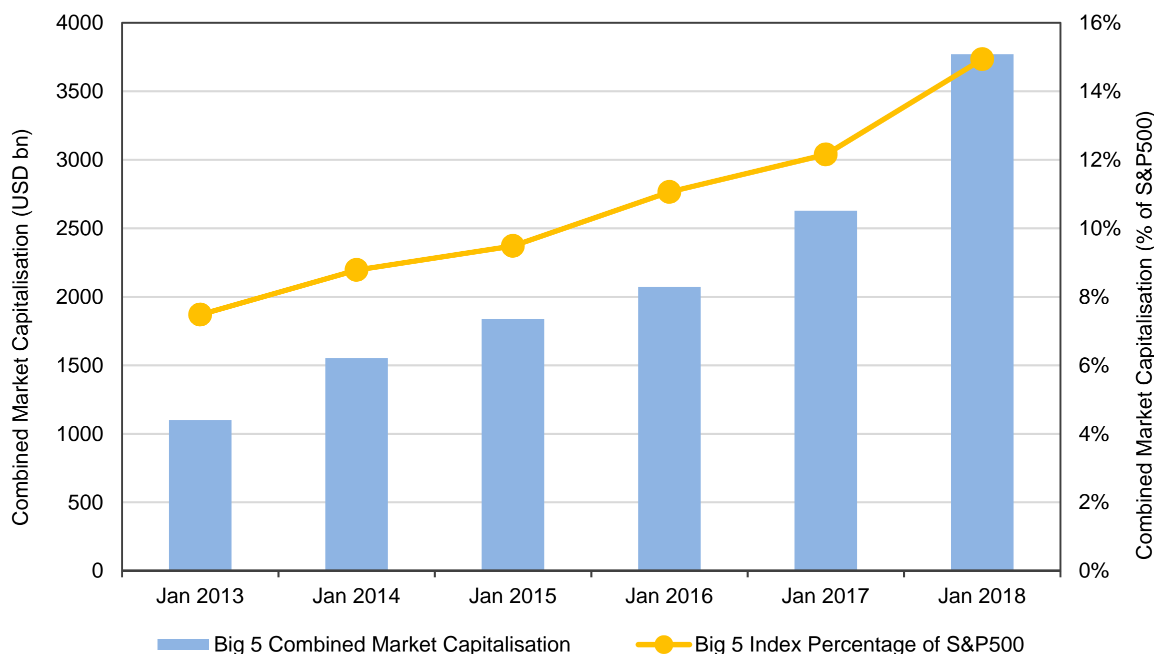
Strongly rising earnings and expanding price to earnings multiples have significantly increased the market capitalisation of these five businesses. Their individual five year return figures, outlined below, are stunning given the size of the companies. Facebook delivered compound returns of 46% per annum. Apple was the laggard delivering *only* 19.7% per annum. They each comfortably outperformed the S&P500.

Company / Index	5 Yr annualised return (13-18)	Market capitalisation (29 Dec 17)
S&P500 Index	15.8%	US$23,367bn
Apple	19.7%	US$851bn
Alphabet (Google)	24.4%	US$719bn
Microsoft	29.6%	US$703bn
Amazon	36.1%	US$701bn
Facebook	46.0%	US$464bn

Source: Bloomberg, Auscap

These five companies were responsible for over 25% of the total performance of the S&P500 Index in this five year period. As the name suggests, the S&P500 index contains 500 companies. These five companies have gone from being 7.5% to 15.0% of the index in this time span. This is considerable concentration for such a large index.

The Big 5 Dominance: AAPL, GOOGL, AMZN, MSFT, FB



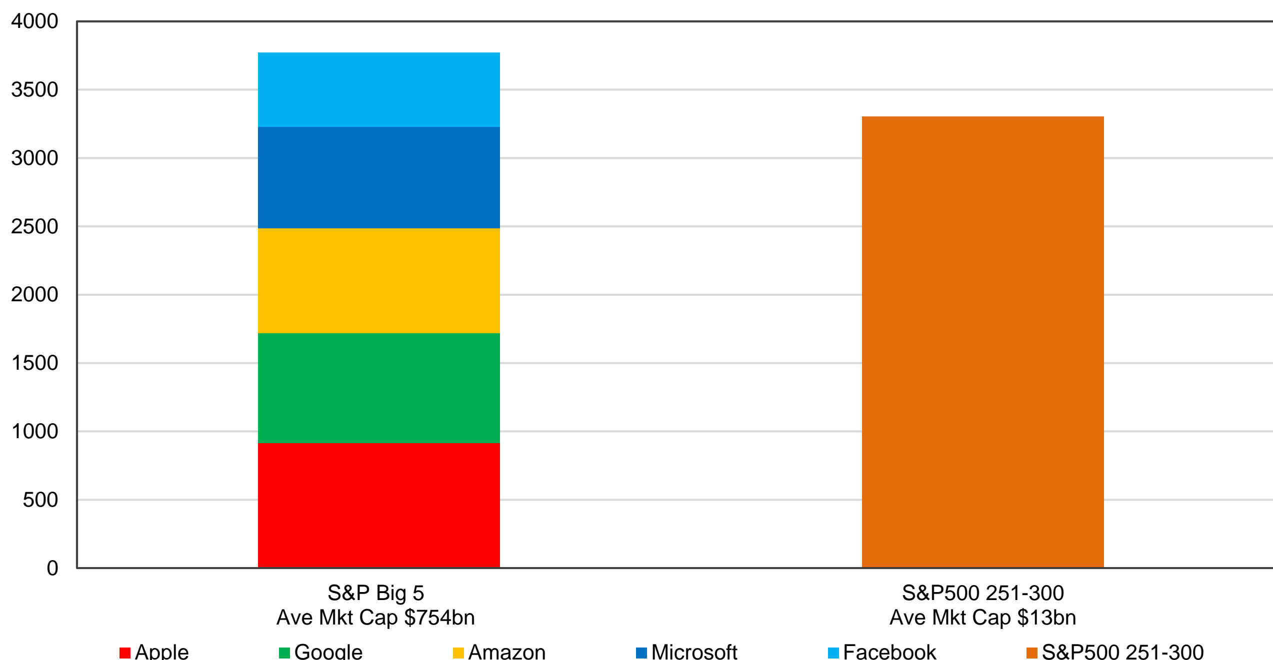
Source: Bloomberg, Auscap

By March 2018, these five companies had a combined market capitalisation that significantly exceeded the combined market capitalisation of the bottom 250 companies in the S&P500. The bottom 250 companies in the S&P500 have an average market capitalisation in excess of $13bn. These are not small companies.

The S&P500 Index has performed so well because of the contribution of, and its significant overweight exposure to, these five businesses. The S&P500, like most indices, is a market capitalisation weighted index. The bigger the company, the bigger the index exposure. So in periods when huge companies in an index are performing strongly, investing passively in that index is likely to be a rewarding experience. Conversely, many active asset managers have not done as well in this period relative to the index because they have been underweight, or not exposed at all, to these big five companies. So their relative performance looks poor.

However, the relationship also holds true when the largest companies in an index are underperforming, as many Australian investors have discovered over the last five years. If the biggest weights in an index struggle to generate growth in revenues and earnings, and do not see an expansion but perhaps a contraction in the multiple that is willing to be paid by investors for these businesses, then investing in the index will prove an unrewarding experience. In these environments active asset managers typically outperform, because they are considering the merits of investing in businesses irrespective of the size of the company relative to the relevant index. Genuine active asset managers size positions according to their conviction, not the size of the business. The best risk adjusted investment opportunities have the highest weightings in the portfolio.

S&P500 Concentration: The Big 5 (March 2018)



Source: Bloomberg, Auscap

Perhaps the outperformance of the technology stocks will persist making a continued passive investment in the S&P500 rewarding for investors. But if growth headwinds start to appear, and risk is more heavily factored into valuations leading price to earnings multiples to contract rather than expand, investing in such an index might prove to be a disappointing experience. We are not in the game of forecasting market sentiment, however we think it pays over time to be aware of the reasons for success or otherwise of particular investment strategies in different markets.

In the Australian stockmarket, we see significant headwinds for growth for many of the largest companies in the domestic indices. As we have discussed in past newsletters, the Australian stockmarket is heavily concentrated. Currently just 16 stocks make up more than 50% of the ASX200. We think in an environment where there are challenges facing these large index overweights, finding the right active asset manager could prove to be fruitful for investors. At Auscap, we continue to employ a value based approach to finding attractive investments in companies whose shares we wish to hold in the Fund for a long time.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website www.auscapam.com and follow the registration link on the home page. Interested investors can download a copy of the PDS at www.auscapam.com/auscap-fund/pds. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

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