Auscap Long Short Australian Equities Fund Newsletter – December 2018

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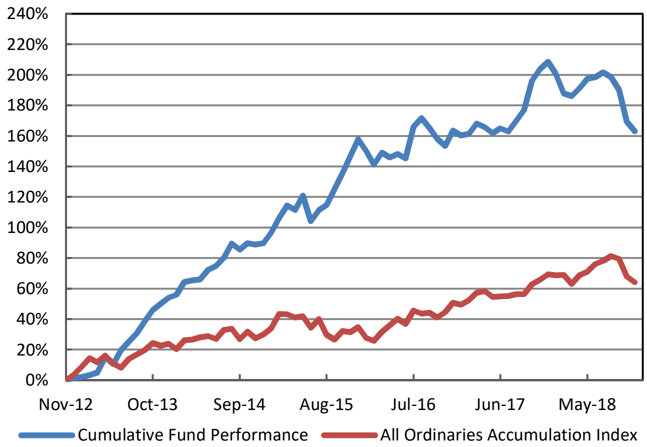
Welcome

Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (Fund). 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 our observations on and response to the recent stockmarket volatility.

Fund Performance

The Fund returned negative 2.33% net of fees during November 2018. This compares with the All Ordinaries Accumulation Index return of negative 2.24%. Average gross capital employed by the Fund was 114.3% long and 4.2% short. Average net exposure over the month was 110.1%. Over the month the Fund had on average 39 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
November 2018	(2.33%)	(2.24%)
Financial Year to date	(11.85%)	(6.80%)
Calendar Year to date	(14.71%)	(3.03%)
Since inception	163.16%	64.12%

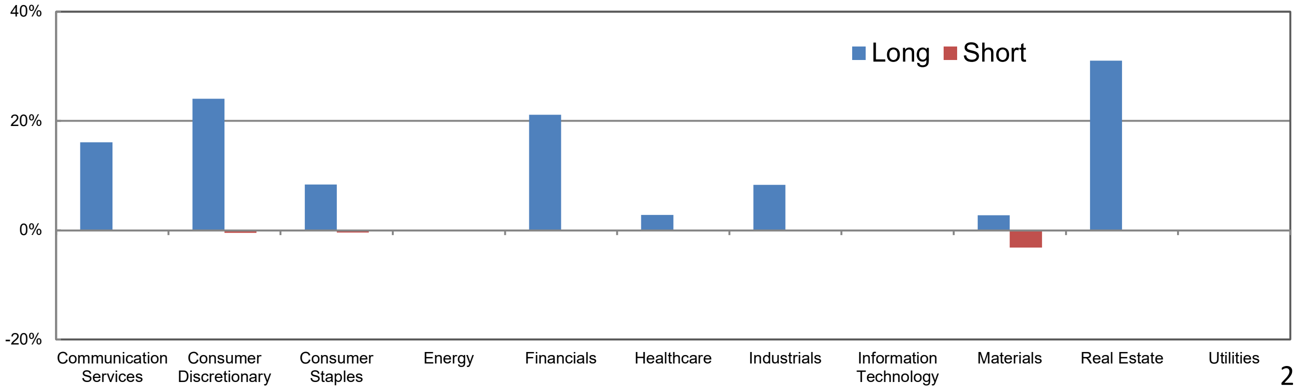
Fund Exposure

November 2018 Average	% NAV	Positions
Gross Long	114.3%	39
Gross Short	4.2%	5
Gross Total	118.6%	44
Net / Beta Adjusted Net	110.1%	87.5%

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	0.39	12.71
FY19	1.02	(0.99)	(2.85)	(7.09)	(2.33)								(11.85)

Sector Exposure - November 2018



Market Observations In Turbulent Times

A confluence of events has rattled global markets. A US–China trade war. A slowing economy in China. Brexit. Mixed signals from the US Federal Reserve. A partially inverted yield curve, enough to create a mild panic. Pockets of significant leverage. Negative returns from most asset classes globally for the 2018 calendar year. Unsettled politics in Australia and globally, with Federal and State elections in Australia early in 2019. It has reminded investors that market volatility can change in an instant. This cocktail of events has led to a reasonably large liquidation of positions. The selling has been unusually indiscriminate. Expensive stocks have been sold down. But so have shares in companies we already considered to be good value. Can it continue? Yes. No one can predict the movement of markets. The key question is what should be done about it.

A few observations about historic periods of volatility:

- Many investors panic at precisely the wrong moment. Selling your stockmarket exposure after a significant decline in the quoted value of the investment is like selling your house after prices have collapsed. Most investors understand that if house prices fall this often provides a long term investor with a good opportunity to buy. But investing in shares elicits a different response, perhaps because it is more abstract than investing in “bricks and mortar” and there is an emotional response that comes with seeing a daily fluctuation in prices.

- Periods of volatility often provide the greatest opportunities for investors who can remain focused on a rational analysis of fundamentals. This is easier said than done. Often those same investors are suffering from a significant drawdown in their own investments. Focusing on reason and adding selectively to the best opportunities can add meaningfully to long term returns.

- No one can predict when a particular stockmarket decline will cease, so we see any such exercise as futile. We instead focus on individual company valuations. If we think we are being offered an attractive opportunity to buy, we start accumulating.

- During periods of stockmarket volatility, the correlation between stock prices increases substantially. However, over time individual stock prices will reflect the earnings of the particular company.

We view a large part of our investment management role as remaining rational at all times. From our perspective this means a number of things:

- If earnings or circumstances for a particular company have changed materially for any reason, we re-evaluate our valuation and view of the company based on this information. If that changes our view on whether the stock is a good investment or not, we focus on not letting our purchase price or historical share prices influence our decision. The companies we own do not know or care what we paid for them.

- Stock prices frequently move both up and down far beyond what is justified by the events, opportunities or risks that the company faces. Company earnings rarely fluctuate as much as their stock prices. In these circumstances, taking advantage of “Mr Market”[1], the extreme enthusiasm or pessimism of other investors, is paramount. We believe that the best way to make money in the stockmarket is by buying great companies when they occasionally trade at attractive prices.

- If nothing has changed in relation to an investment’s prospects but the price has declined significantly, this is an opportunity to add to our exposure.

> *“The most common cause of low prices is pessimism – sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It’s optimism that is the enemy of the rational buyer.”*
>
> Warren Buffett, Berkshire Hathaway

We are currently focused on making sure the earnings of the companies we own are not likely to suffer from a precipitous decline that would justify the recent share price moves. Over the last few months, we have met with quite a number of the management teams of companies that we are invested in, and many more in industries where we see potential opportunities to buy high quality businesses at attractive prices. For companies where we are confident that earnings are unlikely to be affected materially, if at all, by recent macroeconomic events, we view the current sell-off as providing us with a compelling opportunity.

It might seem clichéd, but we find it useful to reference some of the world's great financial minds at times when negativity is pervasive and stocks seem to decline every day. Of all the great historical investors, Warren Buffett has been one of the most prolific at sharing his thoughts on what makes successful equities investing. He is famous for taking advantage of market declines, often at times when many investments in his own portfolio were falling, and despite Berkshire Hathaway's share price also suffering large declines.

> *"You shouldn't own common stocks if a 50% decrease in their value in a short period of time would cause you acute distress."*
>
> Warren Buffett, Berkshire Hathaway

Berkshire Hathaway shares have had significant declines in price a number of times over the last fifty years, as shown below. Warren Buffett and Charlie Munger have consistently added to their equities exposures during periods of widespread stock declines, despite their own share price often suffering from similar declines. While the current decline in the stockmarket does not resemble any of the major historical bear markets, we believe the principle remains that buying individual stocks that have fallen to levels that represent attractive purchase prices, in the absence of compelling evidence of grossly deteriorating earnings, is a sensible strategy.

Period	Drawdown in Berkshire Stock	Movement in S&P500
March 1973 to January 1975	(59.1%)	(31.7%)
October 1987	(37.1%)	(21.8%)
June 1998 to March 2000	(48.9%)	+37.4%
September 2008 to March 2009	(50.7%)	(45.9%)

There is significant pessimism in markets at the moment, and it is creating a number of opportunities for investors with a longer term time horizon. If the market continues to decline, the number of attractive opportunities will increase. While the recent stock price moves are unpredictable and can be disconcerting, the opportunities that are appearing should provide the foundation for solid long term investment.

We wish all of our readers a happy, relaxing and safe festive season and all the very best for the new year.

[1] Mr Market is an allegory Benjamin Graham created in The Intelligent Investor to represent an imaginary investor who invests as a reaction to his mood, rather than fundamental analysis, representative of the short term price movements in the stockmarket.

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