Auscap
Asset Management

# Auscap Long Short Australian Equities Fund Newsletter – November 2018

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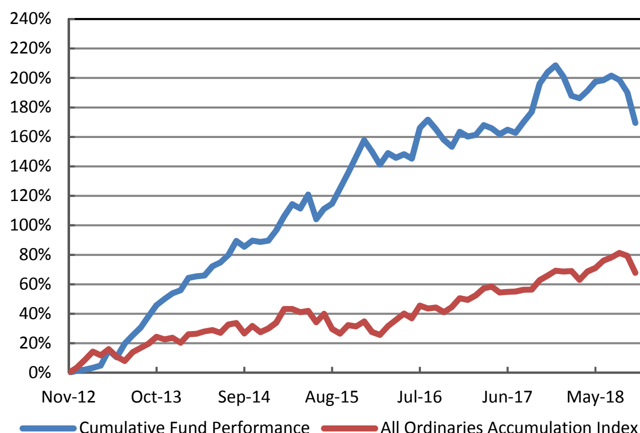
## Welcome

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 the performance of the portfolio over the last three months.

## Fund Performance

The Fund returned negative 7.09% net of fees during October 2018. This compares with the All Ordinaries Accumulation Index return of negative 6.47%. Average gross capital employed by the Fund was 95.7% long and 7.1% short. Average net exposure over the month was 88.6%. Over the month the Fund had on average 35 long positions and 6 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 |
|---|---:|---:|
| October 2018 | (7.09%) | (6.47%) |
| Financial Year to date | (9.72%) | (4.73%) |
| Calendar Year to date | (12.64%) | (0.88%) |
| Since inception | 169.53% | 67.75% |

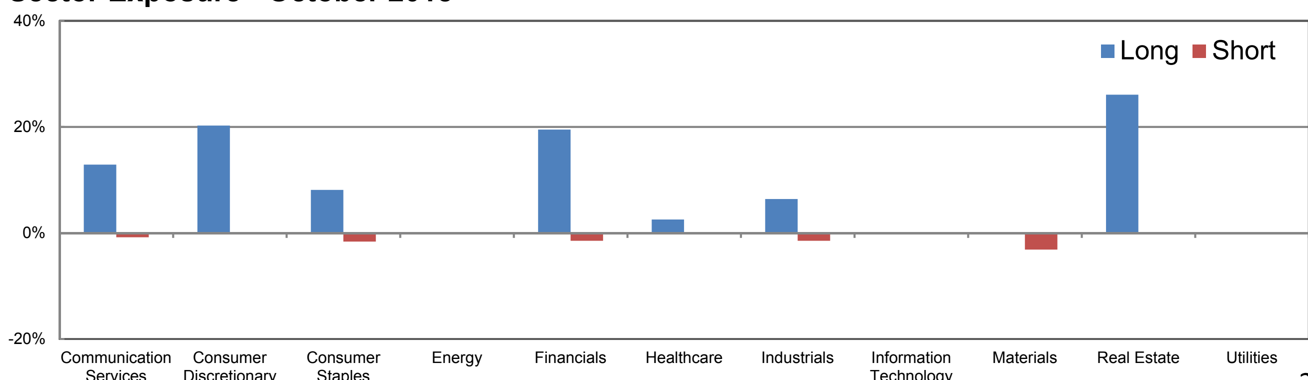
## Fund Exposure

| October 2018 Average | % NAV | Positions |
|---|---:|---:|
| Gross Long | 95.7% | 35 |
| Gross Short | 7.1% | 6 |
| Gross Total | 102.8% | 41 |
| Net / Beta Adjusted Net | 88.6% | 64.1% |

## 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) | | | | | | | | | (9.72) |

## Sector Exposure - October 2018



## Portfolio Update & Opportunities From Volatility

The Fund's performance over the course of 2018, in particular over the last three months, has been disappointing. Whenever performance is poor, our response will always be to increase disclosure and transparency for our investors. We think it is important to provide additional colour for our unitholders when the portfolio is not performing. In this newsletter we outline the causes of the unit price decline over the last few months.

The Fund's portfolio has not responded as we might have expected during a period of volatility. Our view, heading into the August reporting season, was that the market was mildly overvalued and in certain pockets outright expensive. The Fund was defensively positioned going into the September-October sell-off, with 15% of the Fund's assets in cash and another 32% invested in defensive businesses in the real estate and infrastructure sectors. The remainder of the Fund's assets were invested in businesses that we considered to represent compelling value. While the Fund had a lower short interest than the average over the life of the Fund, this was and always is a function of not finding sufficiently attractive individual risk adjusted opportunities that meet all of our criteria. Our gross long exposure was also considerably lower than the historical average. That the Fund's portfolio did not behave as we would have expected is a reminder that a concentrated portfolio's performance will, over the short term, be a function of how those particular stock prices behave and performance volatility can at times exceed the volatility of the broader market.

In our experience, negative markets tend to drag down most stock prices, in the short term, somewhat irrespective of the underlying business performance. Correlations to market movements tend to increase and flow of funds becomes a larger driver of performance than fundamentals. This can lead to periods of short term volatility even from conservatively positioned portfolios. However, these time periods also provide the ideal opportunity to purchase additional investments at attractive prices. This is a way in which we can add meaningful value to the Fund. Hence, whilst we are disappointed at our short term performance numbers, we are positive on the potential it creates for us going forward. Over the medium to long term, the Fund's performance will be the result of our ability to buy growing businesses for less than they are worth.

99% of the Fund's decline over the last three months can be attributed to eleven positions. These include, in alphabetical order, nine long investments in Blackmores, CYBG, Fairfax Media, Janus Henderson Group, JB Hi-Fi, Macquarie Group, New Zealand Media, Nick Scali and Super Retail Group. Most of these companies' share prices have suffered declines of 16% to 20% through the recent period of sharemarket volatility. We consider these falls to be disproportionate to the current and anticipated future state of the relevant companies, and we find it most pertinent to focus this newsletter on the performance of the underlying businesses. Given the volatility in the Fund unit price we therefore thought it worthwhile to provide some brief commentary on the *business updates* that these companies have provided over the last three months. While we can speculate on the causes of share price declines (and we outline a few potential causes below), the actual reasons are impossible to determine. Hence our focus is on business performance rather than share price performance.

**Blackmores** has been a long term holding of the Fund, the initial purchase being made at $25.40 in the early stages of the Fund's life. It is a well-managed, high quality business with all of the attributes we look for in an investment. It has a high return on invested capital, strong cash generation and a sound management team. In August its full year results were released, with group revenue up 9% on the prior year and net profit up 19%. At the AGM in October, it delivered its first quarter result with revenue up 15% and net profit up 7% on the prior corresponding period. Strong revenue growth was seen across all of the markets in which it operates. Net profit growth was lower than revenue growth due to continued investment in marketing, an initiative we strongly support. The opportunity for Blackmores to grow in all of its markets is enormous.

Following its result in August, it could be argued that the stock had become objectively overvalued in the short term. Many companies with strong earnings growth have suffered in the recent decline. Blackmores was no exception. It leads to an obvious question, should we sell shares in a company we wish to own for the long term just because it becomes overvalued in the short term? This is a difficult question to answer. There is no guarantee that the share price will not stay elevated and grow in line with earnings. You might sell the stock and not get an obvious opportunity to buy it back. We have only found a small number of opportunities over the years to add to our position in Blackmores at attractive prices. Any sale also crystallises capital gains for our unitholders, something we are mindful of. Our view is that if we find a company trading at attractive prices with a high return on invested capital and almost unlimited opportunities for reinvestment, we should hold it for the long term. Blackmores is such a business.

**CYBG** is a full service bank focused on consumers and small to medium sized enterprises (SME) operating in the UK. It is the largest challenger bank to the major institutions. It was spun out from its former owner, National Australia Bank, in 2016. The Fund has owned shares since that year. Since then management has been focused on improving the bank's performance. In late July the bank announced a solid performance of lending and deposit growth. In October it completed the acquisition of Virgin Money, a transaction management believe will present significant revenue, funding and cost synergies over the coming years. In October it also received IRB accreditation from the Prudential Regulation Authority in the UK to use its own internal risk models to determine mortgage and SME/corporate credit Risk Weighted Assets, significantly lowering the amount of capital it is required to hold. This capital release is to the benefit of shareholders. Many of the UK financial institutions have sold off on concerns relating to Brexit. Our view is that the likelihood of disruption to the CYBG business from Brexit over the medium term is modest. CYBG now trades on less than 11x forecast FY19 earnings and at a significant discount to its tangible book value.

**Fairfax Media** and **New Zealand Media** have both been undergoing significant structural change for some time. The bygone newspaper business model of classified, advertising and subscription revenues has been challenged in the digital era. Specific sites have taken the classified revenue, and falling advertising and subscription revenues from hard copy paper sales have not been immediately replaced with digital revenues. The traditional businesses are now being valued by the market as though they are in perpetual decline. Yet the demand for both organisations' products, measured by audience size, has grown considerably over the last decade. While audience monetisation has been challenged, product demand has firmed.

Recently there have also been signs that digital revenue growth is starting to counterbalance traditional declines. In October, Fairfax Media updated the market on its revenue growth. The metro media publishing business exhibited flat revenues year on year, an encouraging sign for a business priced at bargain multiples. We continue to believe the audience that each organisation is able to reach due to the strong readership of their publications is undervalued. Already it has enabled Fairfax Media to create successful new businesses in Domain and Stan (the latter with Nine Entertainment Group). While Domain, of which Fairfax Media is still the majority shareholder, disappointed with softer revenue growth over the early months of FY19, we are not surprised by this given the recent fall in housing listings in its major markets. We expect these listing declines to be temporary in nature and we think there is also significant scope over the medium term to increase revenue and earnings through online price rises, increasing depth product penetration and market share growth.

New Zealand Media is working on its own digital initiatives, with the natural advantage that it can promote them to most of New Zealand's population every day at very little marginal cost. Its property portal, OneRoof, is showing encouraging audience growth only six months after launch. New Zealand Media trades on a little over 6x forecast CY18 earnings and Fairfax Media on 13x forecast FY19 earnings. We continue to see considerable value in both businesses, which we expect will grow earnings over the medium term.

**Janus Henderson**, a global fund manager with circa US$378bn of assets under management, released its second quarter results in August. Despite 69% and 64% of its funds demonstrating 1 and 3 year investment outperformance respectively, it is experiencing net fund outflows. These net outflows are currently modest in terms of the overall funds managed by the business. The company continues to extract cost synergies from the merger of the Janus and Henderson groups which completed in May 2017. At 30 June the company had net cash and securities investments of over US$1bn, representing over 20% of the company's market capitalisation, providing opportunities for further capital returns to shareholders over time. The board authorised and has been engaged in an on-market share buyback program of up to US$100m. The company is trading on a little over 8x anticipated CY18 earnings.

**JB Hi-Fi**, **Nick Scali** and **Super Retail Group** are dominant retailers in the categories in which they operate. They have strong cash generation, a good history of return on invested capital and sensibly geared balance sheets. They are all currently trading on between 9x and 11x forecast FY19 earnings. Further, all recently reported reasonable like for like sales growth.

Part of the reason for the sell-off in these stocks stems from broad bearishness on the outlook for the consumer. Recent house price declines and cautious outlook commentary have exacerbated the share price falls.

We acknowledge the following issues facing consumers:

- Household debt is very high in Australia;
- Consumer interest rates have risen modestly recently;
- House prices are currently falling, induced by a credit supply contraction as the major banking institutions adopt more stringent responsible lending criteria (which we ultimately think is very sensible), which could result in a negative wealth effect;
- The savings ratio is currently quite low; and
- Building and construction activity in the residential market is softening from elevated levels.

However, very little attention is being given to a few more positive points:

- Domestic economic growth is strong;
- Population growth is strong;
- Unemployment at 4.9% is very low and reported job vacancies are the highest ever at 243,000;
- Household wealth is high (even allowing for a drop in house prices);
- Interest costs as a percentage of income are relatively low;
- Commodity prices are currently strong;
- Infrastructure spend is very strong; and
- The falling Australian dollar assists many domestic industries (e.g. tourism, commodity producers, manufacturers and retail).

While we are acutely aware of economic cycles, we do not make internal predictions or invest on the basis of any forecast. We will continue to monitor domestic retail sales growth carefully, but believe that overly bearish views on the consumer are not currently supported by the facts.

**Macquarie Group** gave an update on its trading performance in September. It reiterated its previous guidance for a FY19 result similar to FY18 and also highlighted that Macquarie remains well placed to deliver superior performance over the medium term. As we discussed at the Sohn Investment Conference in November 2017, we believe Macquarie Group is a high quality business that we consider to be a core investment in the Fund. We believe its asset management business continues to be undervalued by the market. It is currently trading on less than 14x forecast FY19 earnings. Shortly after month end the company delivered a strong first half result and upgraded its full year guidance.

The Fund's short positions have, collectively, cost the Fund 1.52% in performance over the same period. This has been the result of short positions in the information technology and financial services sectors moving against us, particularly during August. We made the decision to close many of these shorts. We believe that this decision was the correct risk management decision. Our short positions are always stock specific, must meet certain criteria and have a catalyst for profit. We do not short companies simply because they are expensive. A number of the catalysts in relation to disappointing earnings were not realised or, in some cases, simply ignored by the market. As a result, the rationale for remaining short was diminished and we exited the short positions. That many of these short positions have now given up much of the gains made over reporting season is unfortunate, but we will continue to implement strict risk management around our short positions.

We are constantly looking to learn from any exposures that cost the Fund performance. As always, we will continue to analyse these mistakes and refine the investment process. And we will continue to honestly and transparently report on our mistakes and the lessons learnt in our annual performance summary. If our performance is poor, we will always increase our portfolio disclosure and transparency as we have done in this newsletter.

The corollary of the recent market volatility is that the market has corrected quite considerably and the Fund has had considerable cash reserves that we are gradually deploying into opportunities that are being presented. Most of these opportunities are in medium and large capitalisation businesses that are now trading at levels that we find attractive. We are excited by the Fund's exposure to the portfolio of businesses it owns, and we think the outlook for these businesses over the medium to long term is positive.

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