Auscap Newsletter

JANUARY 2020

AUSCAP ASSET MANAGEMENT

Newsletter – January 2020

Auscap Asset Management

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
December 2019	1.9%	(1.9%)
Financial Year To Date	9.5%	3.6%
Since Inception	196.9%	102.4%
Annualised Returns	16.6%	10.5%

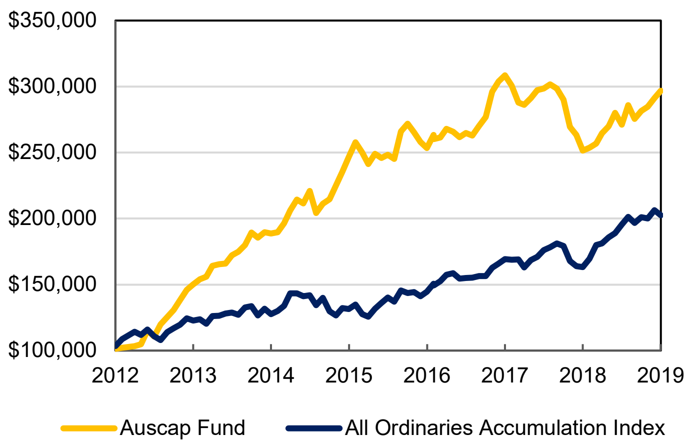
Fund Exposures

December 2019 Average	% NAV	Positions
Gross Long	139.8%	32
Gross Short	7.6%	6
Gross Total	147.4%	38
Net / Beta Adjusted Net	132.2%	122.8%

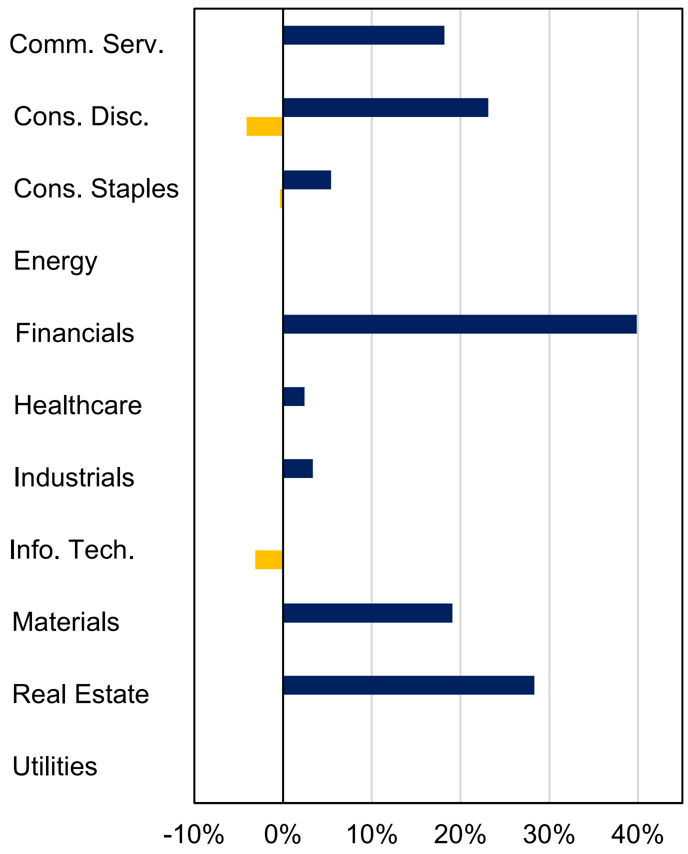
Portfolio Commentary

The Fund returned 1.9% net of fees during December 2019. This compares with the All Ordinaries Accumulation Index return of negative 1.9%. Average gross capital employed by the Fund was 139.8% long and 7.6% short. Average net exposure over the month was 132.2%. Over the month the Fund had on average 32 long positions and 6 short positions. The Fund's biggest stock exposures at month end were spread across the financials, real estate, consumer discretionary, materials and communication services sectors.

Fund Performance*



Sector Exposure - December 2019



Fund Financial Year Returns*

FY13	19.7%	FY18	12.7%
FY14	46.0%	FY19	(9.2%)
FY15	16.8%	FY20 (YTD)	9.5%
FY16	20.1%	CY19	18.1%
FY17	8.0%		

Top 10 Investments^

ANZ Banking Group	Nine Entertainment
Blackmores	Super Retail Group
GDI Property Group	Unibail-Rodamco-Westfield
Mineral Resources	Virgin Money UK
National Australia Bank	Westpac Banking Group

** Performance figures are calculated for the lead series net of all fees and expenses assuming the reinvestment of all distributions. Past performance is not a reliable indicator of future performance.*
^ Top 10 long investments in alphabetical order as at 31 December 2019.

Auscap Global Equities Fund

Fund Performance*

Period	Auscap	MSCI^
December 2019	4.8%	2.2%
Financial Year To Date	7.9%	5.4%
Since Inception (Nov19)	7.9%	5.4%

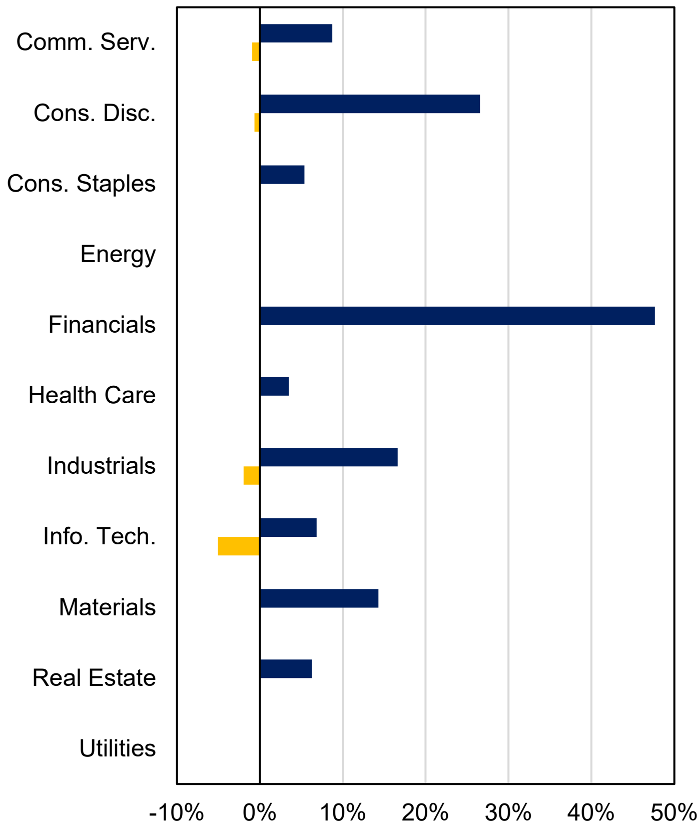
Fund Exposures

December 2019 Average	% NAV	Positions
Gross Long	132.5%	48
Gross Short	7.6%	10
Gross Total	140.1%	58
Net / Beta Adjusted Net	124.9%	123.5%

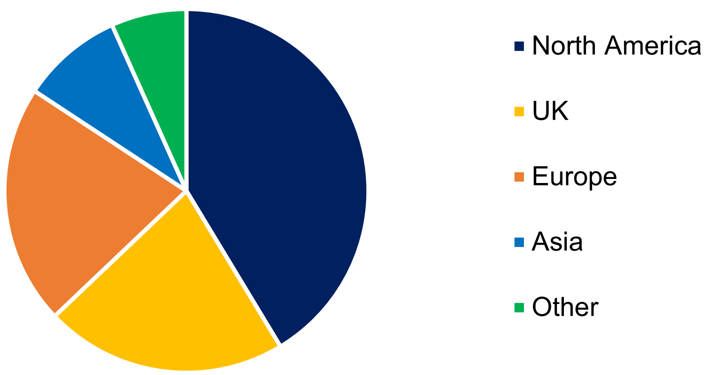
Portfolio Commentary

The Fund returned 4.8% net of fees during December 2019. This compares with the MSCI World 100% Hedged to AUD Index return of 2.2%. Average gross capital employed by the Fund was 132.5% long and 7.6% short. Average net exposure over the month was 124.9%. Over the month the Fund had on average 48 long positions and 10 short positions. The Fund's biggest exposures at month end were in the financials, consumer discretionary, industrials and materials sectors.

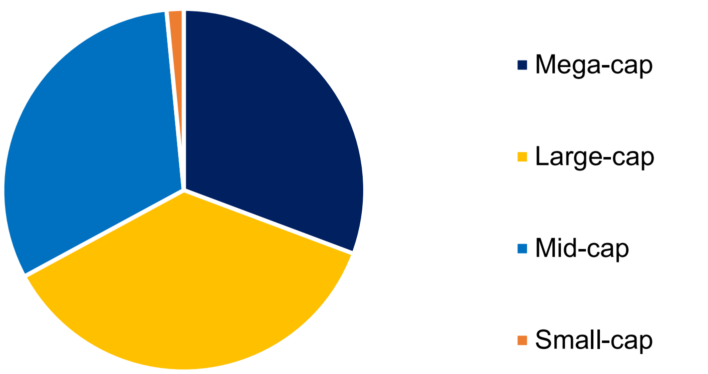
Sector Exposure - December 2019



Exposure by Region



Exposure by Company Size



Top 10 Investments+

Alphabet	ING Groep
American Express	Lloyds Banking Group
BNP Paribas	Macquarie Infrastructure
Capri Holdings	Mineral Resources
Goldman Sachs	Unibail-Rodamco-Westfield

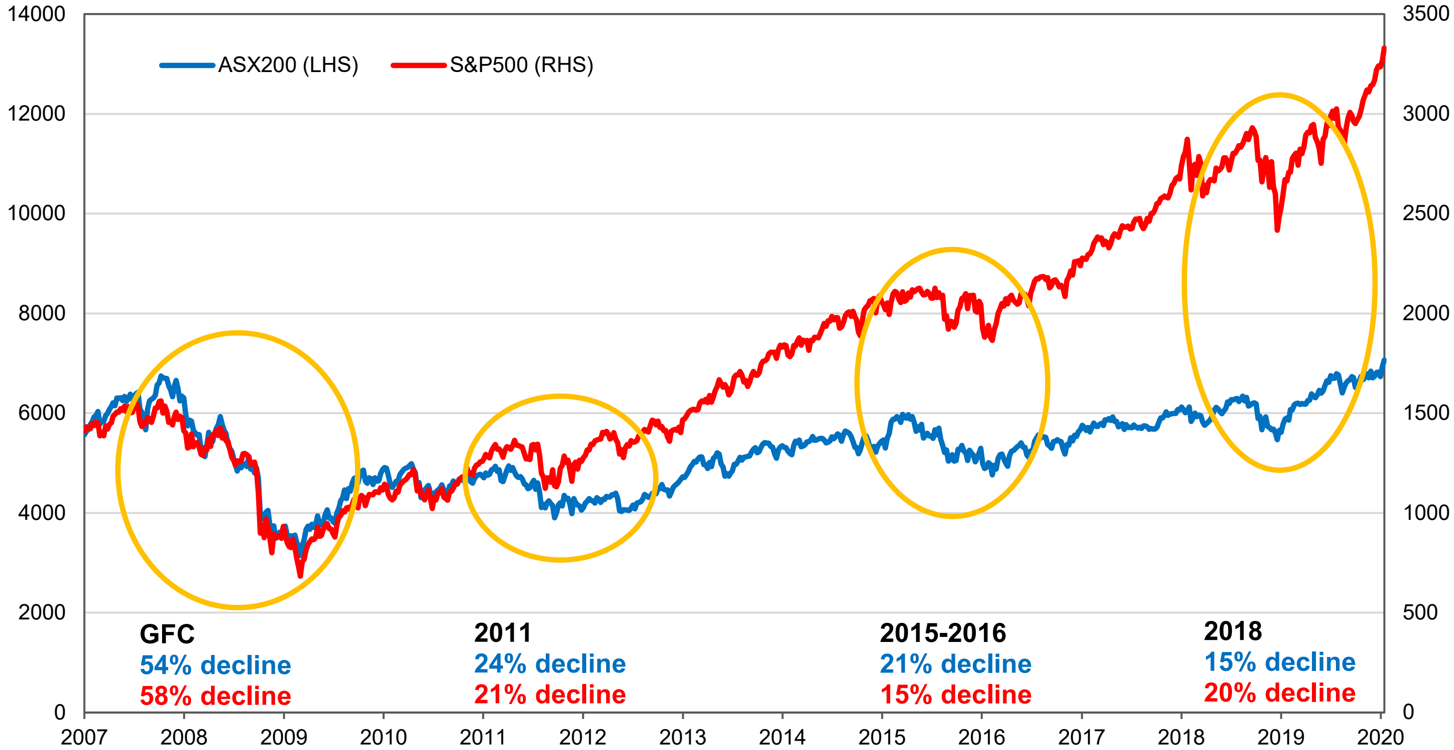
** Performance figures are calculated net of all fees and expenses assuming the reinvestment of all distributions. Past performance is not a reliable indicator of future performance.*
^ MSCI World 100% Hedged to AUD Index
+ Top 10 long investments in alphabetical order as at 31 December 2019.

Are Shares Expensive?

As we enter 2020, "whether shares are expensive" seems to be a topic du jour for those interested in the stockmarket. The Australian indices are recently making new all-time price highs, convincingly surpassing the 2007 peak. So is the market overpriced? And if so, are we due a market correction? To the first question there is no clear answer. The market pendulum swings from one extreme to the other, and it is often only possible to conclude that the market is "cheap" or "expensive" at the extremes. We run through a few relatively simple measures of assessing value below. To us the evidence suggests that we are not at one of the extremes, in which case it would seem wise to have exposure to equities. How one should be invested, by strategy, asset class and investment philosophy might be a more sensible question to ponder. To answer the second question in relation to the likelihood of a market correction requires a forecast that is impossible to accurately predict. As the saying goes, *"forecasts may tell you a great deal about the forecaster, but they tell you nothing about the future"*.

Why are investors concerned? The bull market has, according to many commentators, been going strongly since 2009. Technically a bull market is defined as a period of market growth without a 20% decline. Actually since 2009 there have been three significant corrections in both the Australian and United States stockmarkets, two of which have been in excess of 20%, as shown in the charts below. This might suggest that there have been a number of economic cycles in the ten years since the 2009 lows, but that they have been significantly less severe than the Global Financial Crisis. In Australia there was a resources slowdown in 2011-2012, a mining and energy infrastructure slowdown in 2015-2016 and the property market slowdown in 2018-2019. All were accompanied by market corrections. However, these economic slowdowns have been considered minor, and as a result have not been viewed as interrupting the improvement in the stockmarket since 2009.

ASX200 & S&P500 Index Performance: 2007 - 2020



Human nature tends to result in the expectation that what has happened recently will occur again soon. A great irony is that this negates the likelihood of this occurring because it changes behaviour. When to expect the next Global Financial Crisis, or a similar stockmarket meltdown, is a favourite subject of conversation. The fact that it remains fresh in the minds of many market participants most likely results in more cautious overall investor behaviour, therefore reducing the likelihood that there will be sufficient reckless behaviour to create the preconditions for such a decline until such lessons are forgotten by the majority.

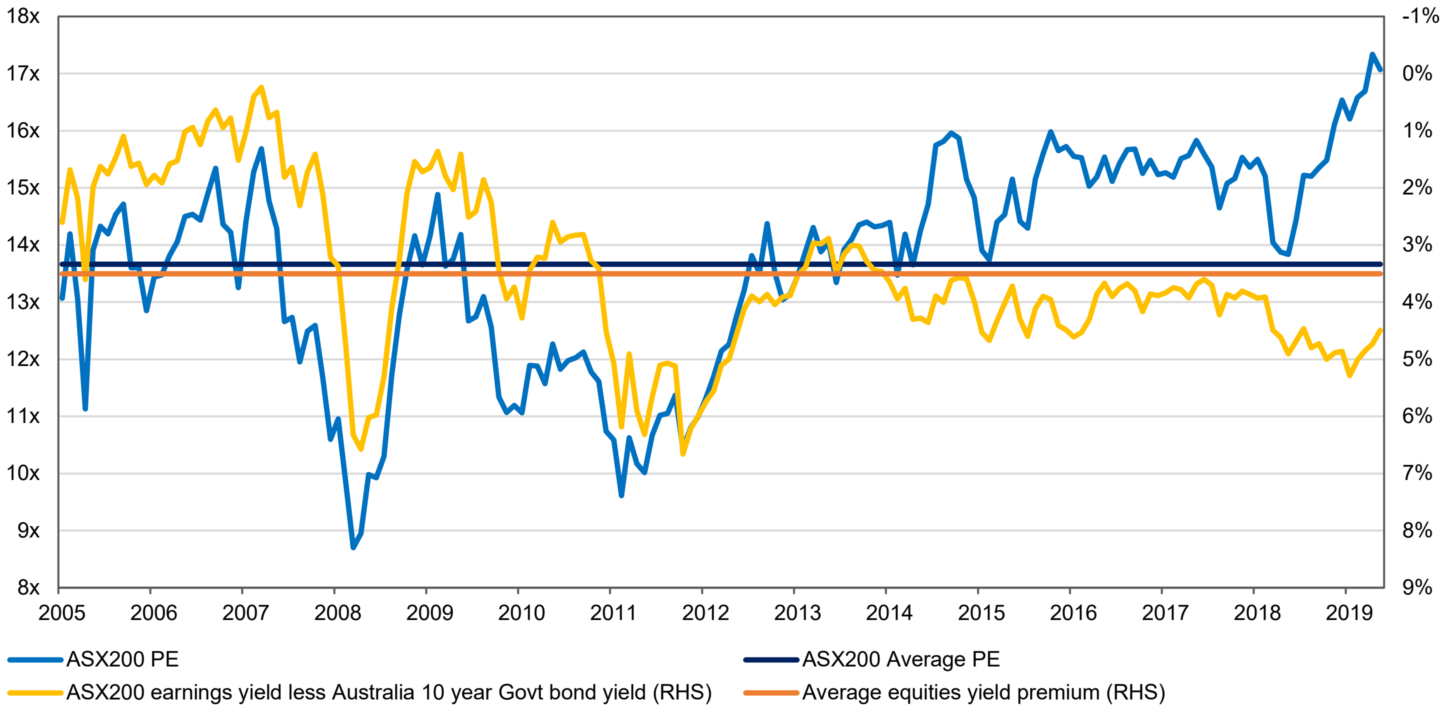
However, that it not to say that one should not pay attention to a myriad of signs that might indicate whether there is value on offer in the stockmarket. Investors can monitor observable absolute and relative value measures of the stockmarket and compare them to history. While this information is an imperfect guide to future events, it can establish a framework for one's approach to investing. When the market or particular sectors are compellingly cheap against the historical averages, it would seem sensible to increase one's exposure to the market or these sectors *ceteris paribus*. If sentiment is particularly cautious this should also act as a bullish indicator for investors. When stocks or sectors are expensive compared to history or other asset classes, caution is warranted, particularly in the presence of overt optimism or euphoric behaviour by market participants. As Warren Buffett reminds us, "*the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs*". The very fact that many are questioning whether now is the time to sell might well be a counter indicator, signifying broad discipline in relation to exposure to the market.

One simple and common measure of assessing value is to analyse price to earnings ratios (PEs) over time. It should be noted that simple measures are often convenient but incomplete guides to assessing value, whether this be in relation to equities, bonds, property or other asset classes. The PE ratio is far from a perfect measure, and does not account for differences in current or prospective earnings growth rates, inflation and interest rates. To the extent there is a relationship between nominal interest rates, inflation and economic growth, this is the purpose of also assessing measures of relative value. In this case analysing the difference in yields between equities and bonds is a proxy for the real return offered by equities.

Investing in Government bonds will result in a nominal yield that is measureable and certain, assuming no default. Investing in equities is riskier, and the equity holder has a claim on the earnings of the business, which we express as an earnings yield, as well as future growth in the earnings of the business. The difference in the yield offered by the Government bond and the company, plus the company's future growth in earnings, can be thought of as the premium available to investors for assuming the additional risk of investing in the company. While there is no reliable and consistently measurable way of assessing future earnings growth, analysing the simple "yield premium" can be informative. A larger yield premium suggests that an investor is receiving additional compensation for taking on risk. It is often a good time to buy stocks when the yield premium is elevated. In the charts below we have inverted the yield premium so that readers can assume that buying when either chart is low is preferable to buying when the chart is high.

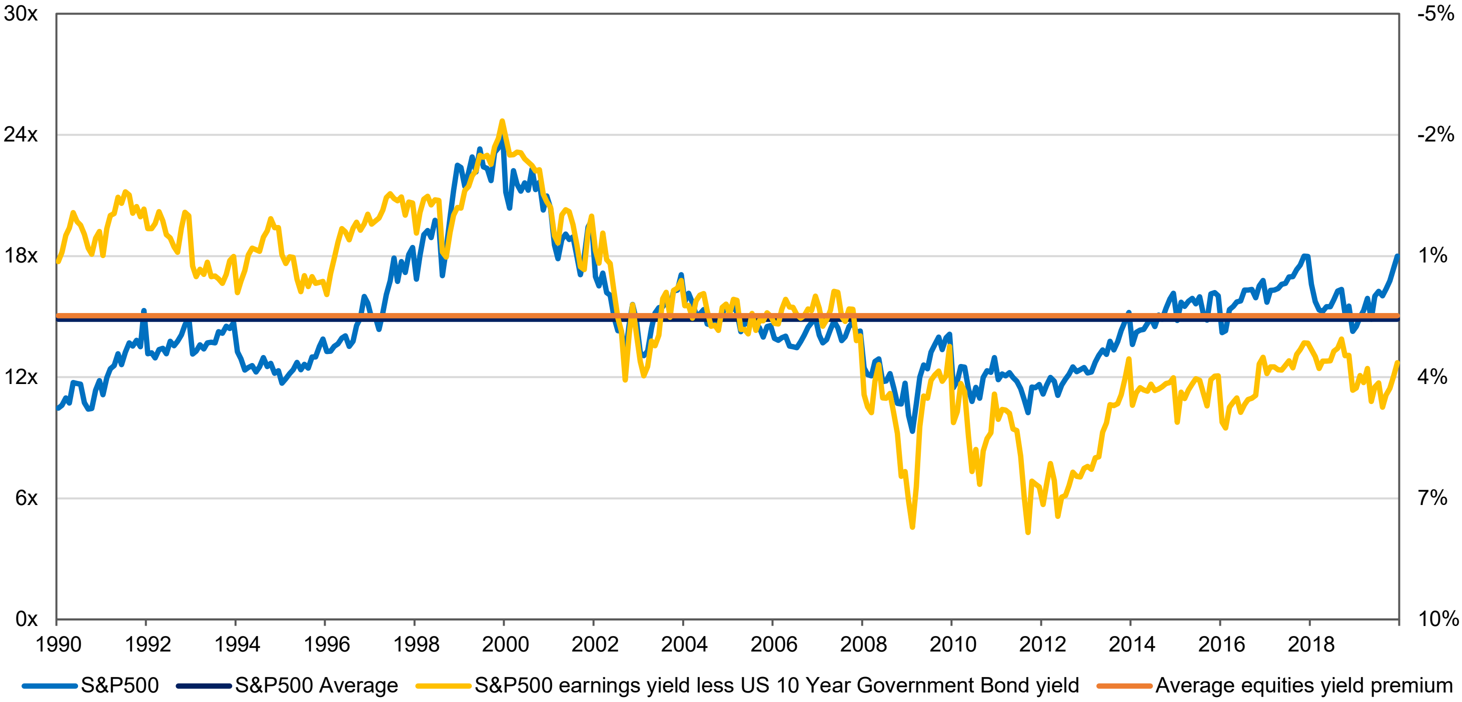
The ASX200 is trading at an elevated PE compared to its average over the last 15 years, suggesting that in absolute terms the market is expensive. However, with interest rates at record lows, the differential between the yield offered by Government bonds and equities is also elevated, indicating attractive relative value. While the average PE gives the appearance of the market being expensive, the market continues to look cheap compared to Government bonds. Historically these two indicators have acted in concert, whereas currently they provide conflicting signals, in large part due to the low global interest rate environment.

ASX200 PE Ratio & Earnings Yield Premium



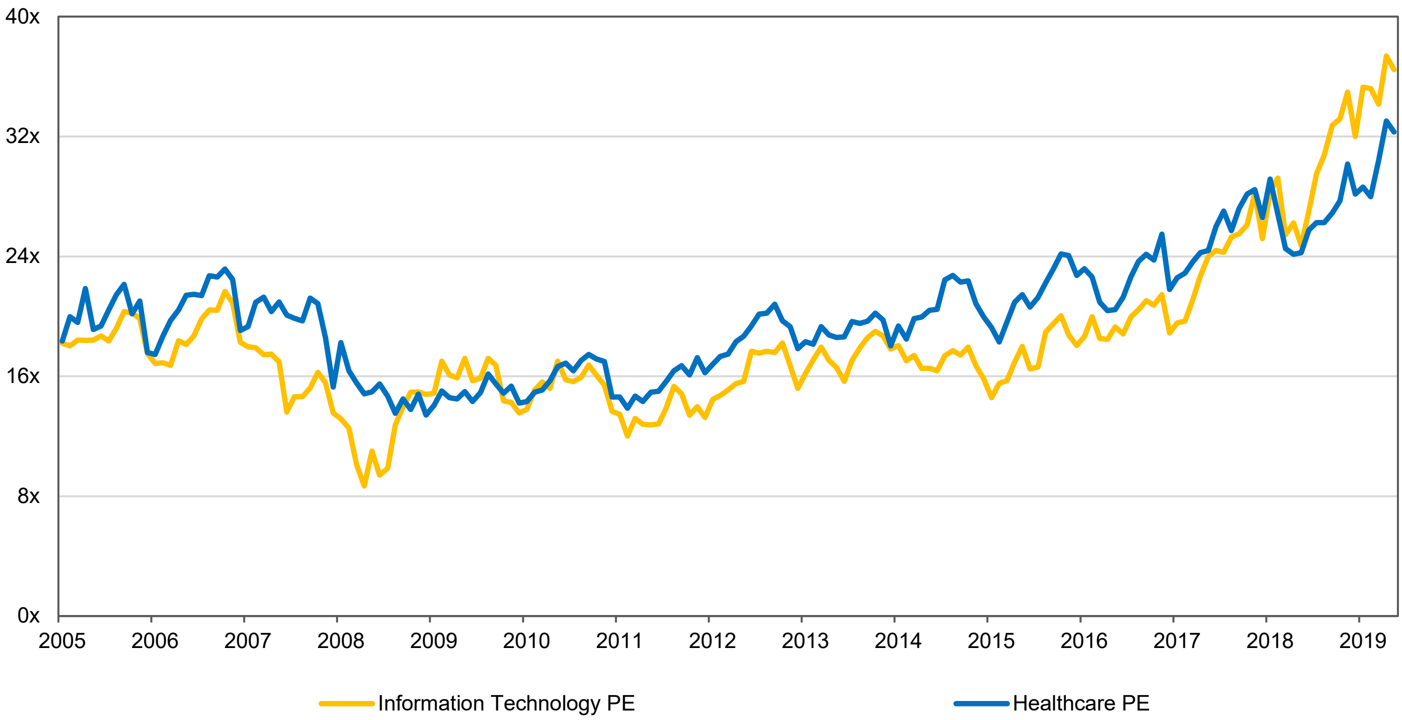
This phenomenon is replicated in the United States. If we look at the PE of the S&P500, it is significantly above the long term average. However, the earnings yield premium offered by equities over bonds is also elevated, indicating relative attractiveness. It is difficult to draw a conclusion that stockmarkets are either expensive or attractive.

S&P500 PE Ratio & Earnings Yield Premium



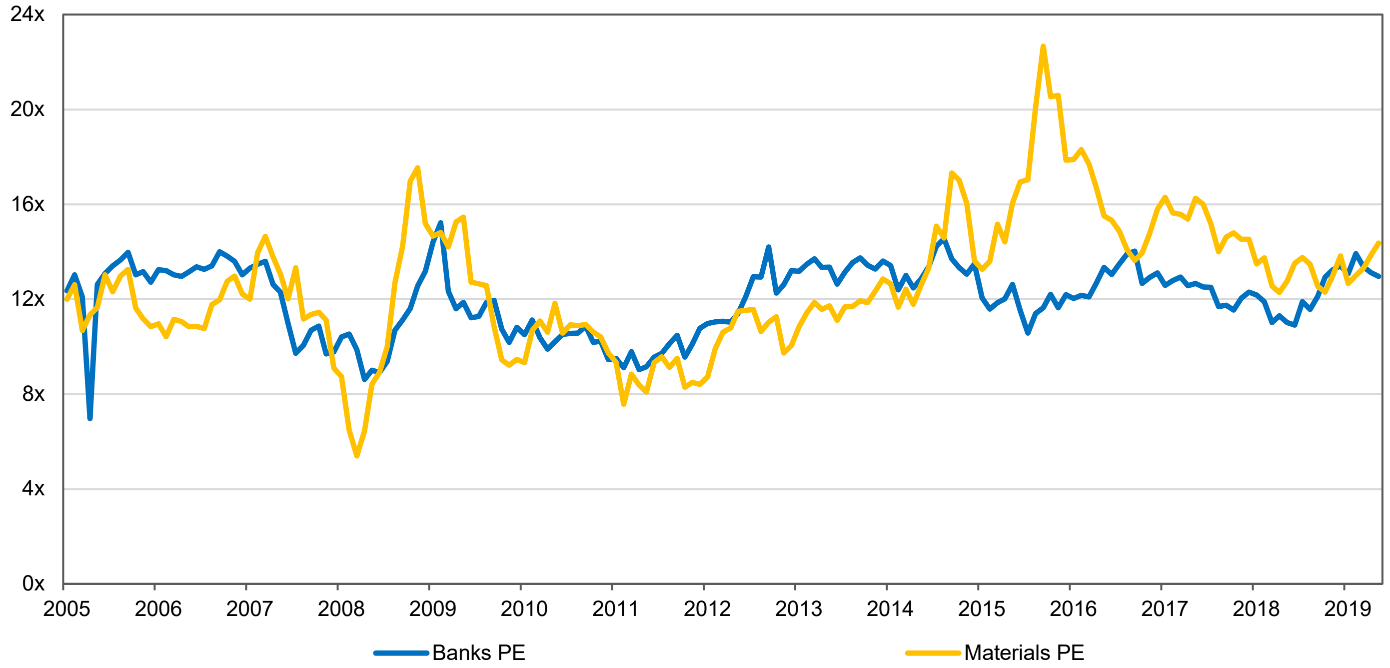
Further analysis suggests that simply assessing the broad market averages can be misleading. In Australia, the Information Technology and Healthcare sector PEs are extremely elevated against history.

ASX200 Information Technology and Healthcare PE Ratios



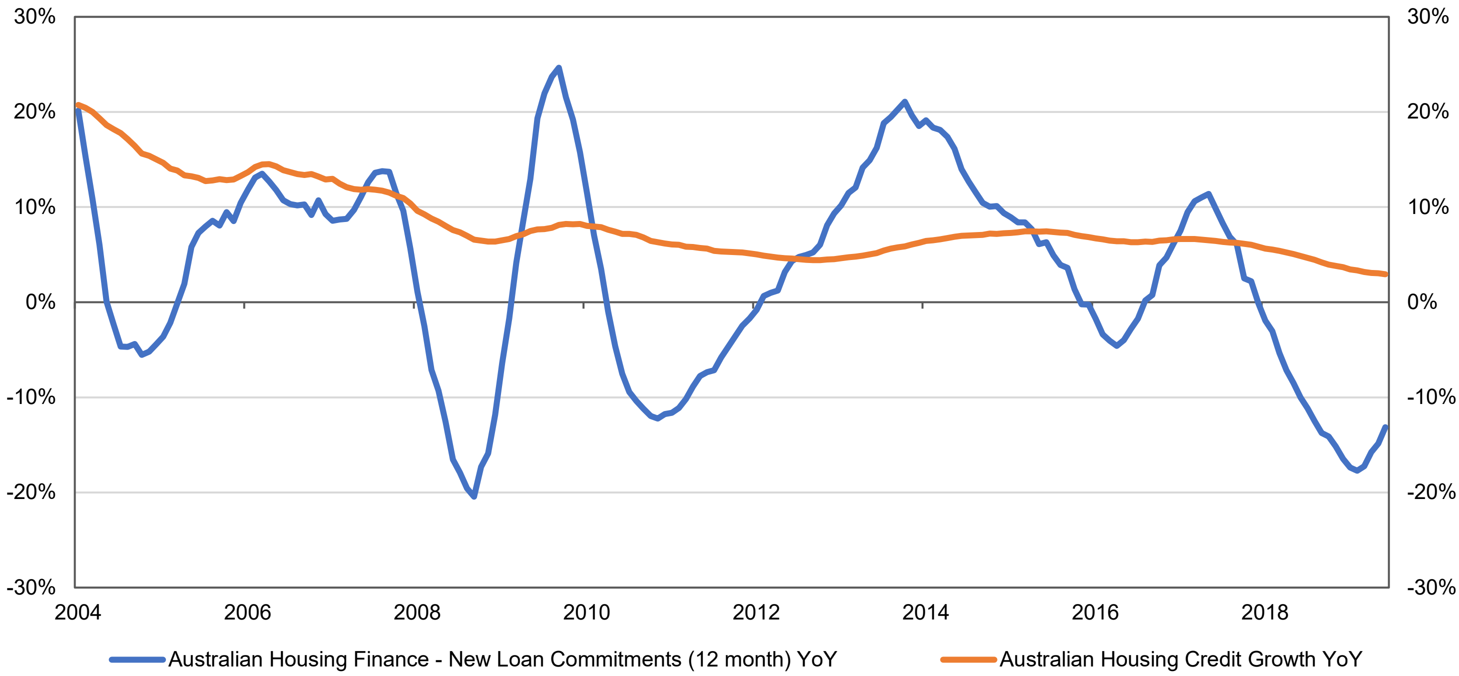
By contrast, the Banks and Materials sectors, which make up approximately 39% of the ASX200, are trading with PEs not far above their historical averages.

ASX200 Banks and Materials PE Ratios



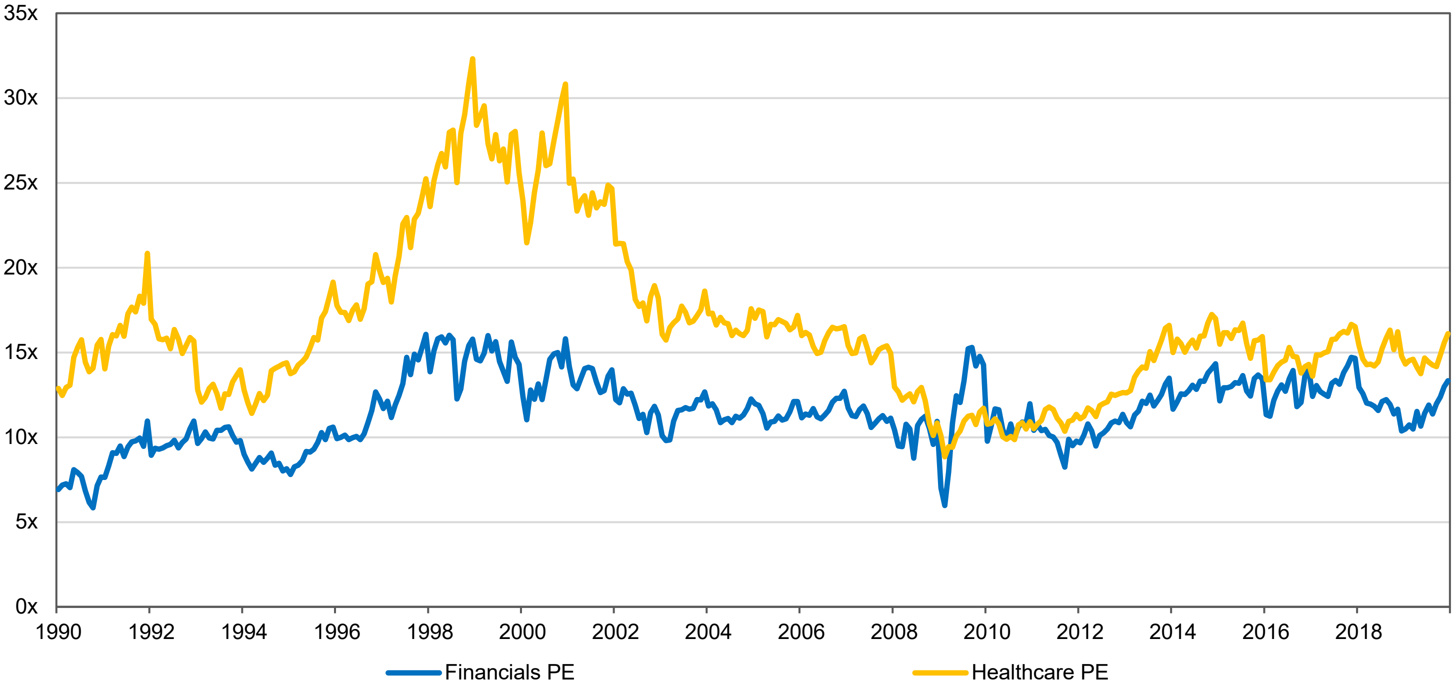
Both sectors should benefit if there is an improvement in global and domestic growth. Interestingly, new housing loan commitments have shown some recent improvement following the largest decline in activity since the Global Financial Crisis.

Australian Housing Finance Growth



Similarly in the United States, despite the market trading at an elevated PE ratio, there are pockets of relative value. Financial companies remain reasonably good value from a PE perspective. Any improvement in economic activity should act as a tailwind for sector earnings. Healthcare companies continue to trade at a small discount to the long term averages.

S&P500 Financials & Healthcare PE Ratios



Clearly using only two indicators to assess market value is a simplistic and imperfect approach and not one that we recommend. We do so to demonstrate that often measures of value will produce different conclusions. We also note that there are many nuances to the valuation debate that we do not discuss here for the sake of brevity. Assessing the overall attractiveness or otherwise of investing in stocks requires an investor to build a great number of indicators into a framework that becomes an investment approach. We analyse the data to look for sensible investments at a country, stockmarket, sector and single stock level.

Our broad conclusion is that the domestic and global stockmarkets look neither cheap in absolute terms nor particularly expensive relative to other asset classes. However, the divergence in valuation multiples within the major stockmarkets is considerable. We continue to see considerable pockets of value, particularly at the company level, and are enthusiastic about the investments in our portfolios. As a result, both the Auscap Long Short Australian Equities Fund and the Auscap Global Equities Fund continue to be relatively fully invested. Our focus remains on investing in predominantly large and mid capitalisation companies that are growing, have a strong track record of return on invested capital, produce significant cash flows for investors and are trading at attractive prices. We look forward to 2020 and wish all of our readers the best for the year ahead.

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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 for the Auscap Long Short Australian Equities Fund at www.auscapam.com/auscap-fund/pds. Eligible investors can download a copy of the Information Memorandum for the Auscap Global Equities Fund at www.auscapam.com/globalfund-information-memorandum/. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

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