Auscap Newsletter

Auscap Long Short Australian Equities Fund

JULY 2022

AUSCAP ASSET MANAGEMENT LIMITED

Auscap Asset Management

Recession, Rates & Rising Risks: The Rationale For Remaining Positive

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The Auscap Fund (Fund) has had a significant pullback in the first six months of this year, following strong performance in 2021. We view this as an opportunity. We believe that many companies held in the Fund have continued to perform strongly from an operational perspective. In this newsletter we discuss recent Fund performance and delve into the disparate performance of the different parts of the Australian stock market. We explore the recent weak investor sentiment which has resulted from concerns around inflation, interest rates and the risk of recession. With consensus expectations now centred on reasonably negative outcomes, and with reasons to believe outcomes are likely to be more positive than this perception, we outline how we try to use the swings in market psychology to our advantage. Finally we discuss recent changes that have enhanced the overall quality of the portfolio and our positive disposition to our current investment exposures.

The newsletter is organised as follows:

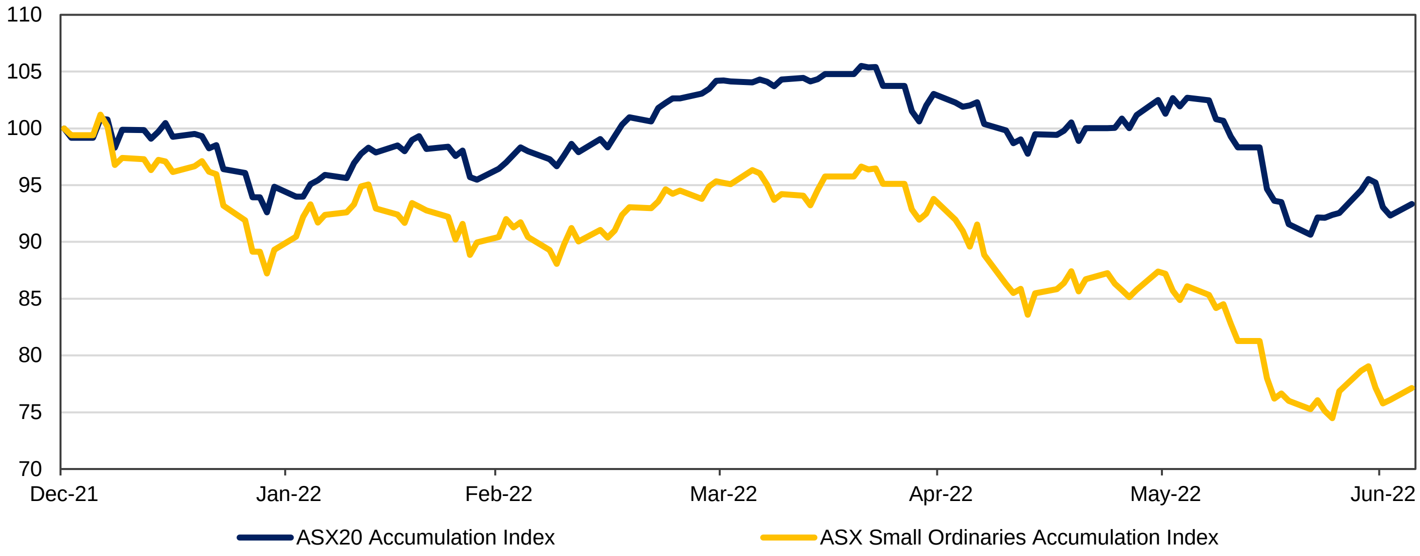
1. Recent Auscap Fund and Stock Market Performance

The Fund has declined 25.4% in the first six months of 2022. This compares with a decline of 11.5% for the All Ordinaries Accumulation Index (Index) in the same period. We see that much of the difference is explained by the Fund's limited exposure to the ASX20, being typically the largest 20 companies listed on the ASX, which have meaningfully outperformed the remaining stocks in the Index. The Australian indices are somewhat unusual. Not only does the domestic stock market have a heavy concentration in banking and mining stocks, but the top 20 stocks by market capitalisation represent 54.8% of the Index. The Fund has very little exposure to these 20 stocks. In fact, at 30 June 2022 the aggregate exposure to these ASX20 stocks was just 6.6%. In the recent selloff, the performance of the top 20 stocks has been markedly better than the performance of stocks outside the top 20. Because of the heavy exposure to the top 20 stocks this has led to much stronger performance by the All Ordinaries Index than stocks outside the ASX20.

Index	Average Stock Performance (31 December 21 to 30 June 22)
All Ordinaries Index	– 11.5%
ASX20	– 5.4%
All Ordinaries Index ex ASX20	– 23.4%

The table above illustrates that the average stock in the All Ordinaries Index is down considerably more than the All Ordinaries Index itself. The recent selloff has been significant for many individual companies. This is also reflected in the performance of the Small Ordinaries Accumulation Index as compared to the ASX20.

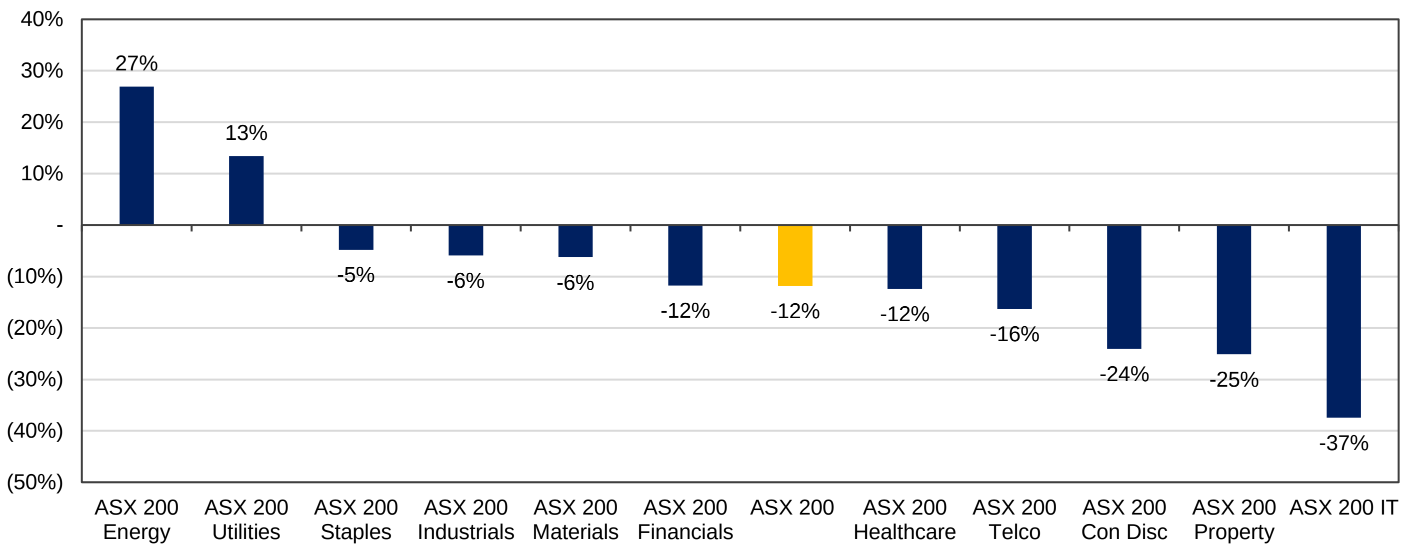
ASX Index Performance (Rebased to 100)



Source: Iress, Auscap

Further, there has been considerable dispersion in returns at the sector level. The Fund's performance relative to the Index is also explained by the Fund's overweight exposure to sectors such as Consumer Discretionary and nil exposure to the Energy and Utilities sectors, which are not just the only sectors in positive territory for the year but are up 27% and 13% respectively.

YTD ASX 200 Index Performance



Source: Iress, Auscap

It is a reasonable question to ask why we have these relative overweights and underweights. We invest based on the characteristics of the particular companies. We want high return on capital businesses that have reinvestment opportunities that will allow them to grow earnings for many years. We are long term investors in these businesses and so we tend to have relatively consistent overweight and underweight exposures to different sectors. The Fund presently has a considerable exposure to consumer discretionary companies. We are invested in these businesses primarily as a function of bottom-up analysis that indicates they are compelling long term investment opportunities. Further, as we will examine below, we think the evidence supports the proposition that Australian households are well placed to face a range of possible future economic outcomes, and the range of likely outcomes will still provide these businesses with opportunities to continue to grow earnings over time.

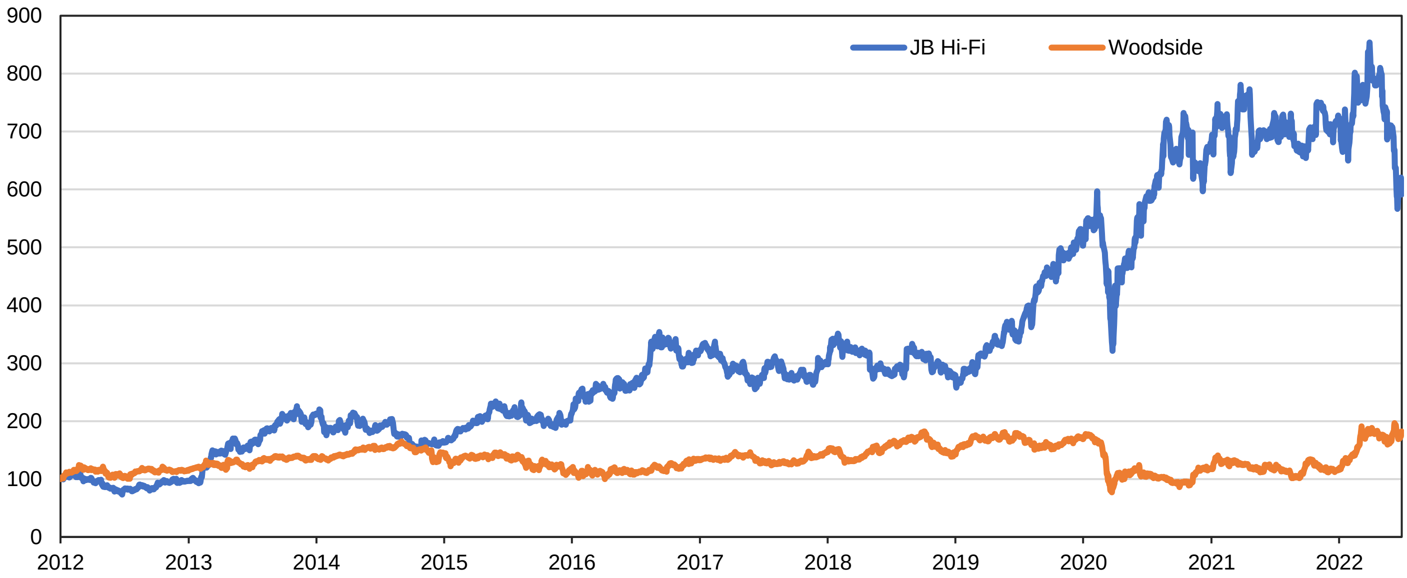
By contrast, we feel comfortable having no exposure to sectors that generate poor returns on capital and which, our analysis suggests, will deliver mediocre outcomes for shareholders over time. For example, we do not attempt to "time the market" to capture short term moves in commodity prices. So our underweight exposures, such as our limited exposure to domestic energy companies, utilities and banks, are also consistent over time. As a result it is sensible to expect that the Fund's performance will deviate meaningfully from that of the broader market at different stages.

Indeed, genuine active stock picking is likely to result in very different performance to that of an index which measures the performance of companies on a market capitalisation weighted basis. We concentrate the Fund's capital in investments that we think will result in the best long term compound returns for our investors. A concentrated portfolio is much more likely to exhibit higher volatility than a broad index which, because of the number of constituents, generally has lower exposure to the performance of individual companies. Cyclical swings in individual stocks have little effect on the index because of the considerable number of stocks comprising it and the relatively small weight typically attributed to individual companies. This is not the case for concentrated portfolios.

We would argue strongly against the notion that volatility is equivalent to risk. To us, risk is defined as the prospect of permanent loss of capital. Volatility reflects the swings in price over time in response to both changes in a company's earnings expectations and, just as significantly, investor sentiment. Further, our view is that volatility tells you little about how much you have been compensated for the risk of investment, because it just tells you how much the stock moves around, rather than giving directional information.

To illustrate using a simple example, Woodside Energy Group (Woodside) and JB Hi-Fi have both been mainstays of the ASX200 over the last decade. Woodside is a large crude oil, natural gas and other petroleum product producer. JB Hi-Fi is a large electronics retailer. If we assessed stocks in terms of their riskiness only based on volatility, one might conclude that Woodside is the safer investment. Its 10 year volatility is 27.3% compared to 30.0% for JB Hi-Fi. Therefore, over a long time horizon, JB Hi-Fi has experienced greater price turbulence. But this is precisely why we say that risk and volatility are not the same thing. Over that period JB Hi-Fi has delivered an annualised total return of 18.5% compared to 5.9% for Woodside.

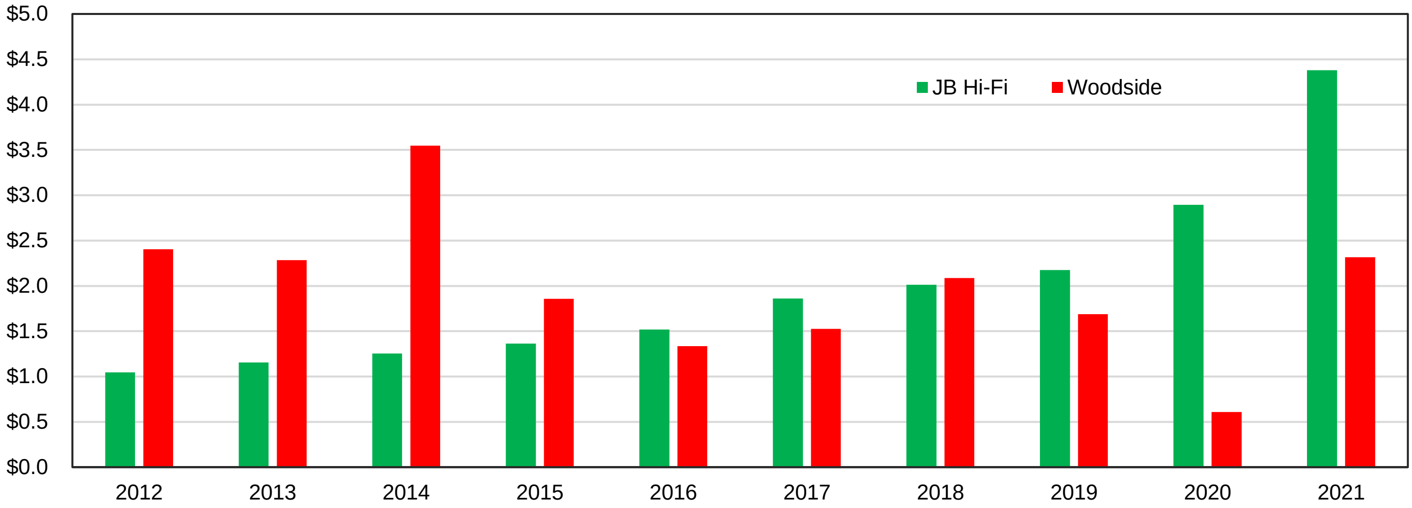
JB Hi-Fi vs Woodside Total Return



Source: Iress, Auscap

Further, JB Hi-Fi has delivered consistent Earnings Per Share (EPS) growth, while Woodside have seen declining earnings in 4 of the last 10 years, with 2021 EPS slightly lower than it was in 2012.

JB Hi-Fi vs Woodside EPS



Source: FactSet, Auscap

We would much rather have owned JB-Hi-Fi over the last decade than Woodside. JB Hi-Fi is a best-in-class retailer exposed to the positive trends of growing utilisation of electronics in the home, population growth and increasing household consumption over time. By contrast, Woodside has to manage complex operational risks to extract oil and gas from frequently remote and deep underground reservoirs, is subject to the vagaries of movements in the oil price, achieves considerably lower through-the-cycle returns on capital, is exposed to a variety of legitimate ESG concerns and ultimately faces an uncertain future as we move towards green energy sources. Yet if we focus on stock price volatility, one might conclude that JB Hi-Fi is the more risky investment, because its daily price volatility has been higher over this period. Further, because of the recent increase in the oil price, over the short term Woodside has considerably outperformed JB Hi-Fi, up 51.4% calendar year to date compared to JB Hi-Fi which is down 19.2%. We do not structure the Fund's portfolio around predictions of short term movements in commodity prices with uncertain longer term outlooks, but rather we prefer to own businesses that we think will continue to compound earnings at attractive rates over time.

So the question really becomes, how can we use share price volatility in the names that the Fund owns, or we would like it to own, to our advantage over time? We examine this in the next section.

2. Our Approach to Managing Changes in Investor Sentiment

"In the short run the market is a voting machine, but in the long run it is a weighing machine"

Benjamin Graham

The ramifications of this statement, one that we consider to be a truism of financial markets, are significant. It means that in the short term sentiment, dictated by human psychology and emotion, can be the predominant driver of share prices, rather than the performance of the companies themselves.

Market participants have two options in relation to how they respond to the wild swings that represent the extremes in market psychology – to use them to their advantage, or to let them act to their disadvantage. We try to use these swings to our advantage where possible. We attempt to do this in a number of ways:

- Where market sentiment is extremely bullish and opinion is close to consensus that the outlook for a given company or sector is extremely positive, we often pare back our exposure. This is typically a favourable time to do so because stock prices are unusually high, reflecting the positive mindset of most participants.

- Where market sentiment is extremely bearish and pessimism is pervasive, we focus on taking advantage of opportunities to buy more of great companies, and seek to optimise the portfolio in circumstances where we do not wish to simply add gross exposure.

- Where sentiment is neither extremely bullish nor bearish, we spend very little time trying to guess where it will go in the near term. We have found this a futile exercise, incapable of being consistently replicable. Further, trying to predict where sentiment will go, which is a reflection of the change in sentiment across all market participants, has the potential to consume considerable time that is better spent assessing the characteristics, performance and future prospects of current and prospective investments.

The outcome of the third point is that a portfolio can be relatively fully invested, with broad market sentiment relatively neutral, and suddenly exposed to a significant negative shift in market psychology. We believe that this is an unavoidable feature of being invested in markets, particularly as a long term investor where we focus on delivering returns by selecting attractive investments and letting their earnings growth dictate performance over the medium to long term.

This is what has happened recently with a number of macroeconomic and geopolitical events negatively impacting the psychology of market participants, along with an unwind of a large bubble in technology related stocks and cryptocurrencies. This does not mean that during these periods attractive opportunities cannot be taken advantage of. We have been actively trying to improve the quality and risk adjusted return characteristics of the Fund.

It also does not mean that changing economic circumstances should be ignored and expectations not adjusted accordingly. Changing circumstances will invariably make some investments more or less attractive than they were previously, which needs to be assessed objectively and then acted upon to the extent that it dictates modifications to the portfolio. All investing is both relative and absolute. If there are more compelling investment opportunities than ones already held in the portfolio then we will reduce certain positions, even when they are below fair value, to invest in these more compelling investment propositions. This is what we describe as portfolio optimisation. But this is very different to using swings in market sentiment to one's disadvantage by acting on negative sentiment, news stories and frequent reporting of tail risks to sell stocks at a time when, on the balance of probabilities, they fundamentally reflect good value.

The Future Is Unknowable

All investing is probabilistic because the future is inherently unknowable. No one has successfully and consistently predicted what is likely to transpire even a few short years into the future. The last few years are proof enough of this.

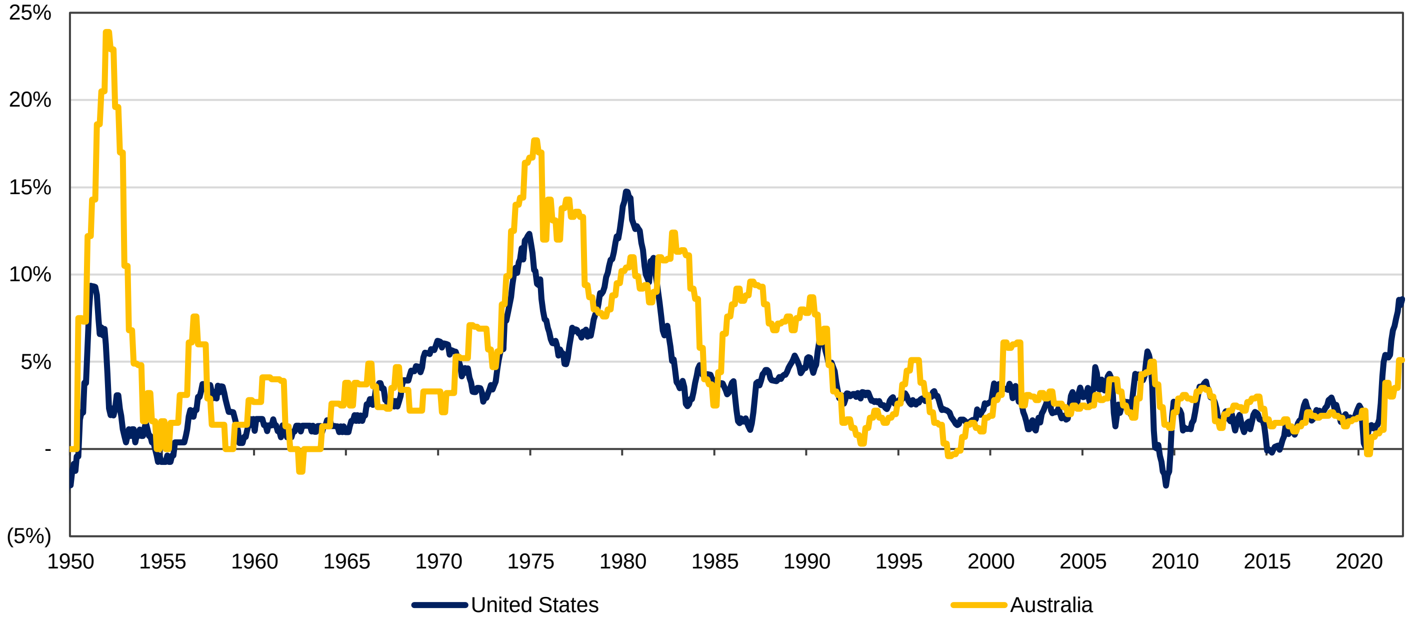
By contrast we can assess present circumstances objectively to determine different potential future outcomes and assign some likely probability to them. Understanding what has happened historically can provide a useful framework for determining what is likely and less likely to happen in the future.

At present there is a strong narrative in financial markets that the current inflation rate, which is very significant, is likely to persist for some time. As a result, central banks are raising interest rates rapidly around the world. It seems that market participants are assuming, as indicated by forward curves, that aggressive rate rises are going to continue for some time, which will place considerable stress on households, resulting in a decline in consumption that weakens economic activity likely leading to a recession in the next few years. While the logic is fairly straightforward to follow and the conclusions would appear robust, it is important to recognise the many assumptions that are being made to reach this conclusion. It is likely that any significant assumption that turns out to be incorrect will invalidate this thesis. We run through our broad thoughts on these key topics below, starting with inflation.

3. Inflation

Inflation is the topic du jour. And for good reason. Inflation in the United States is at the highest levels in 40 years, running at a staggering annualised rate of 8.6%. In Australia inflation was 5.1% as at the end of March, the highest reading in over 20 years. As a result, market participants are fixated on the impact to financial markets from central banks trying to lower these numbers through interest rate increases. But as legendary investor Stanley Druckenmiller has said, "*never, ever invest in the present … you have to visualise the situation 18 months from now, and whatever that is, that's where the price will be.*"

CPI Growth Annualised (%)



Source: FRED, Auscap

It is worth considering what inflation is likely to be in a year's time. To do this, one needs to understand why it is so elevated currently.

US Federal Reserve Chairman Jerome Powell has identified three overlapping root causes for the current global spike in inflation: the war in Ukraine (impacting agricultural, chemical and energy commodity prices), disruptions to global supply chains (including shipping costs, Chinese lockdowns and semiconductor shortages) and the interaction of tight labour markets with strong demand conditions. We would add expansionary monetary and fiscal policy to this list.

The most recent US inflation reading was largely driven by three consumer price index (**CPI**) components with high weightings: energy, food and vehicle prices. Growth within these areas *directly* represented about 60% of the 8.6% inflation number, despite an approximate weighting in the CPI basket of only 29%. We think it is important to analyse input price trends in these individual categories to understand the likely forward trend in inflation.

(%)	Energy	Food	New Vehicles	Used Vehicles	Shelter	All other factors	CPI
May-22 Inflation Rate	34.6%	10.1%	12.6%	16.1%	5.5%	4.5%	8.6%
CPI Weight	7.3%	13.4%	4.1%	4.1%	32.9%	38.1%	100%
CPI contribution	**2.5%**	**1.4%**	**0.5%**	**0.7%**	**1.8%**	**1.7%**	**8.6%**

Source: US Bureau of Labor Statistics, Auscap

Energy

Energy prices are a direct component of the CPI and have wide indirect impacts, such as on transportation costs and agriculture prices. The WTI Crude Oil Price reached $130.50 in March 2022, soon after the Ukraine conflict began, but has since drifted 22% lower, to now sit at approximately $102.

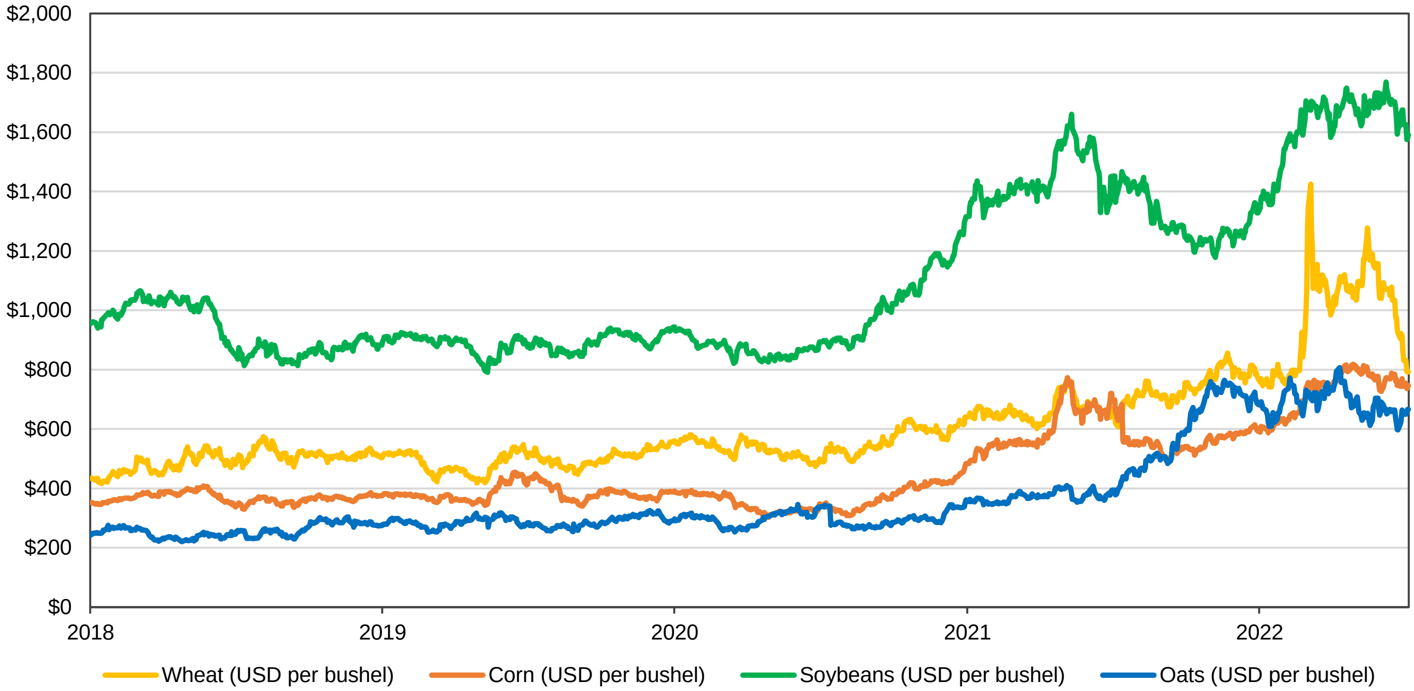
West Texas Intermediate (WTI) Crude Oil Price (USD)

Source: IRESS, Auscap

Food

Key agricultural commodities such as wheat, corn and soybeans rose sharply in the second half of 2021 and the start of 2022, but have since either stopped increasing or begun to fall.

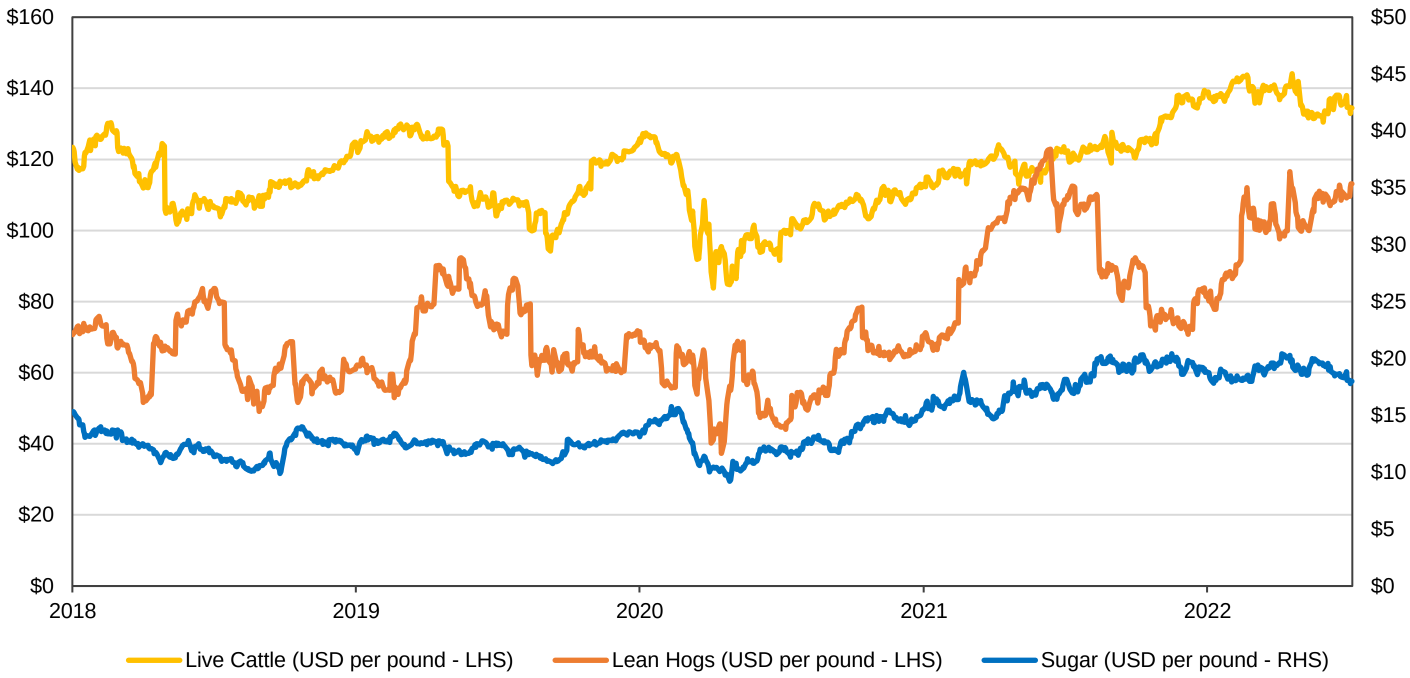
Soft Commodity Prices: 2018 to Present



Source: Bloomberg, Auscap

Similarly, live cattle and lean hog prices have risen but presently appear to be plateauing. Sugar prices have been relatively flat over the last year.

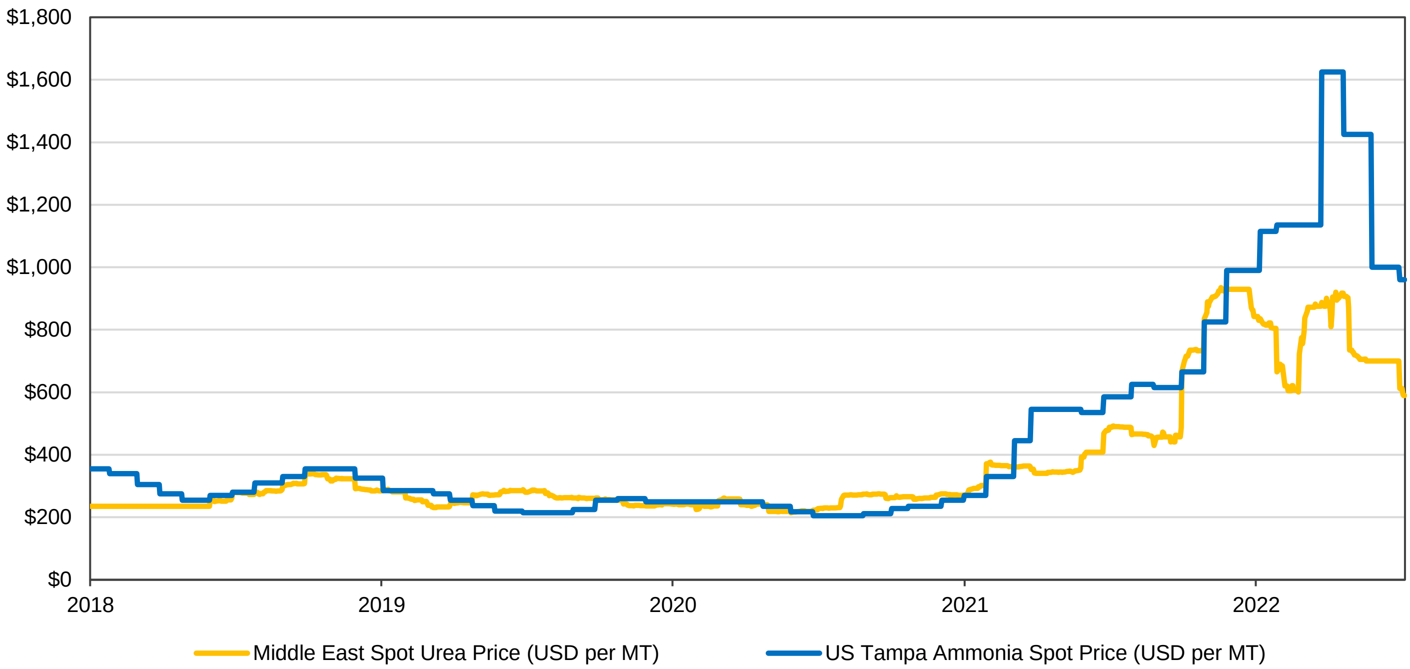
Soft Commodities: 2018 to Present



Source: Bloomberg, Auscap

Two of the major input costs into fertiliser, and therefore food prices, are urea and ammonia. Both commodities have seen significant price increases from the start of 2021. These have recently begun to abate, albeit prices are still very high compared to previous years.

Fertiliser Input Commodities: 2018 to Present

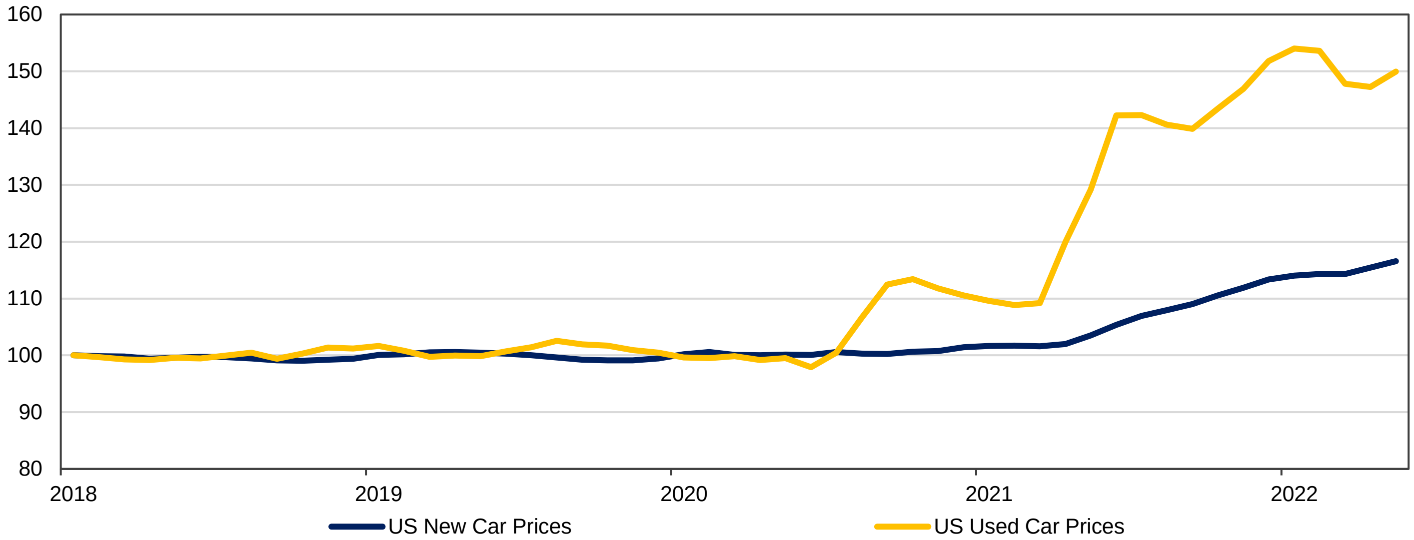


Source: Bloomberg, Auscap

Vehicles

In the United States, used vehicle prices peaked in February 2022, having experienced their sharpest increase on record in April – June 2021, the period we are now cycling.

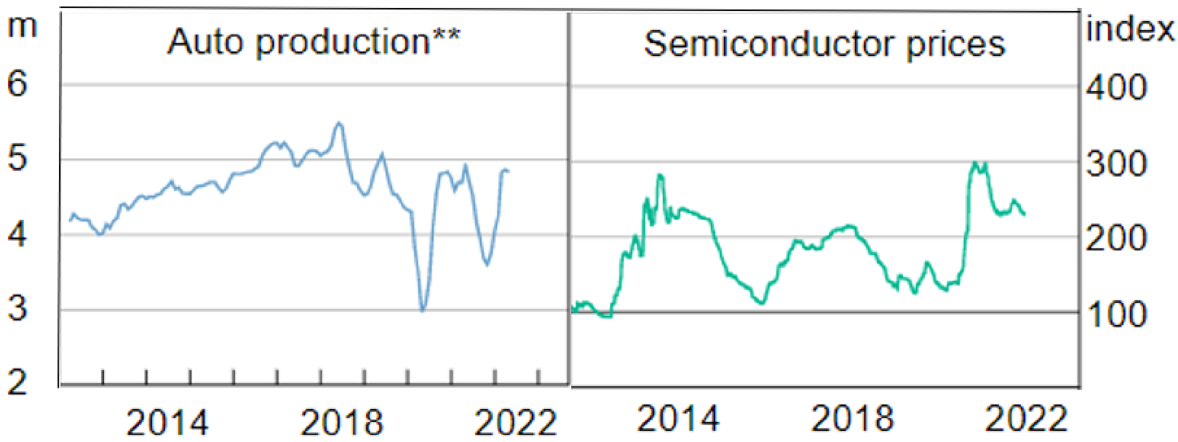
US New & Used Vehicle Prices (Index rebased to 100)



Source: FRED, Auscap

While new vehicle prices are still rising, semiconductor prices (semiconductors are the key new vehicle supply bottleneck) appear to have peaked and vehicle production levels appear to have largely recovered to pre-COVID levels. We anticipate a gradual easing in automotive price growth as the backlog in demand is cleared. It should be noted that a clearing of this order bank backlog is yet to be seen in the data.

Automotive Supply Chain Indicators

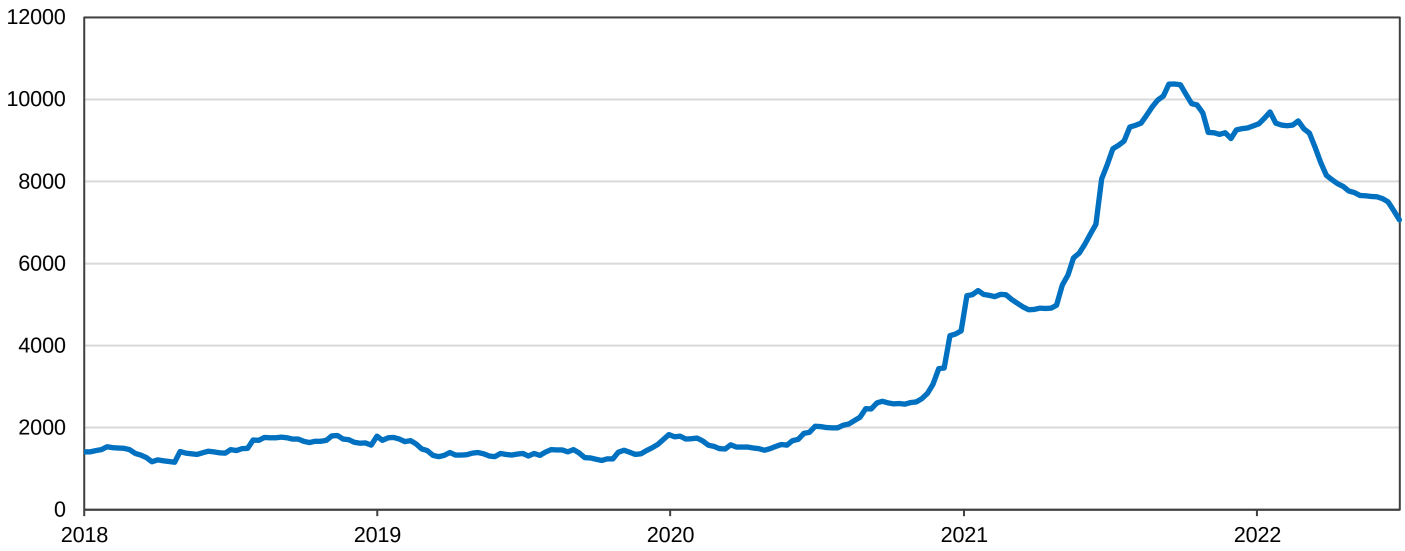


Source: RBA

Supply Chain Disruption

Supply chains have been disrupted as a function of COVID-induced lockdowns, elevated demand and transport congestion. We think it is reasonable to anticipate that both the lower production and elevated demand for goods as a result of COVID-induced lockdowns will continue to normalise over time. Shipping container rates, which rose exponentially at the start of the pandemic, are now dropping sharply from their September 2021 peak. New shipping supply, China's gradual reduction in lockdown restrictions and a slowing of US consumer demand in certain categories are probable contributors to this drop.

Drewry WCI Composite Container Freight Rate (USD per 40 Foot Box)



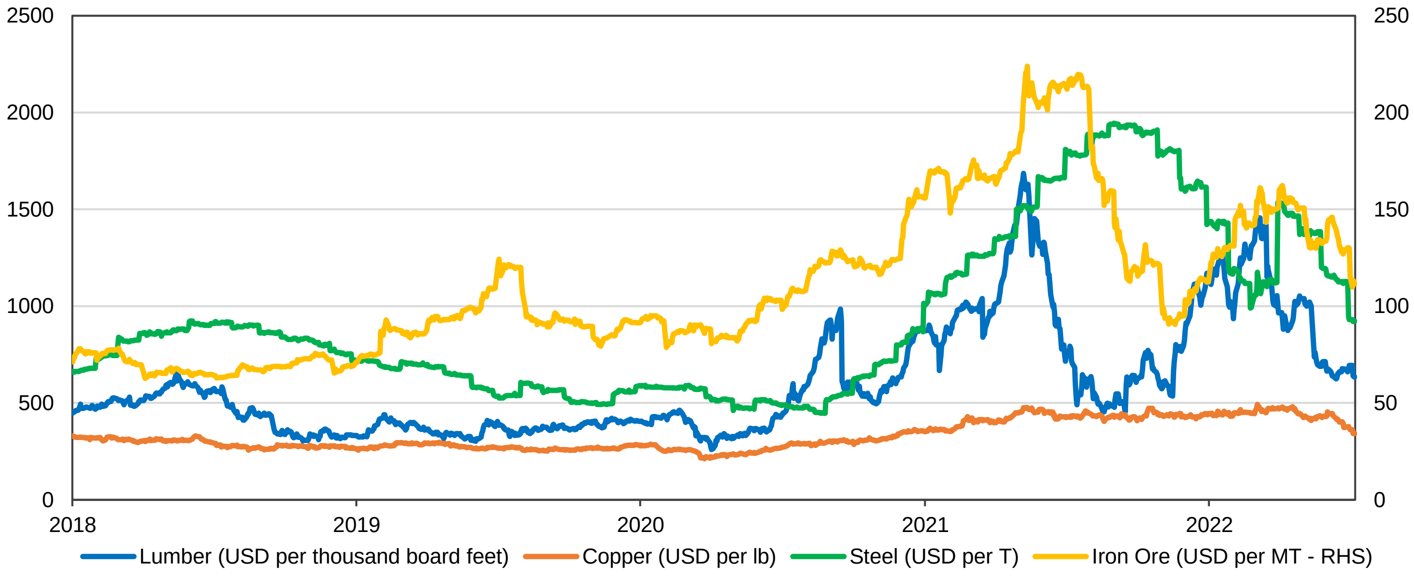
Source: Bloomberg, Auscap

<u>Housing</u>

Housing, or "shelter", is a large component of the CPI basket in the US and therefore warrants a mention. The majority (74%) of housing's CPI weighting is derived from a measure of implied rent called "Owners' Equivalent Rent", a survey taken over time of what property owners believe their property would rent for if offered to market. It is very difficult to assess what drives this measure. Therefore, there is a chance that despite declines in inflation in other categories, this survey, along with potential increases in actual rental costs (22.5% of housing costs), continue to rise and sustain inflation at higher levels. Whilst this could be a factor in the near term, offsetting falls in other inflation components, over the medium term it would appear unlikely to continue if house prices were to decline in response to rising rates, a reasonable assumption, and in an environment where the cost of replacement housing was falling.

Inflationary forces in relation to the cost of housing construction, whilst not having a large direct CPI impact, affect the cost of meeting new demand for residential property. In late 2021 and early 2022 many construction materials increased in price substantially, but since then much of this price pressure has abated.

Hard Commodity Prices: 2018 to Present



Source: Bloomberg, Auscap

Monetary Policy Effects

Monetary policy is becoming increasingly restrictive. Quantitative easing is winding down and the Federal Reserve's balance sheet is shrinking. The US Federal Funds Rate has been hiked 150bps at the last three meetings and further aggressive hikes have been flagged. The Reserve Bank of Australia (RBA) has raised rates 125bps in its last three meetings. Other major central banks are generally adopting the same approach and asset prices globally have fallen sharply. The likely effect of higher rates is the suppression of demand, which again is likely to reduce the inflationary impulse.

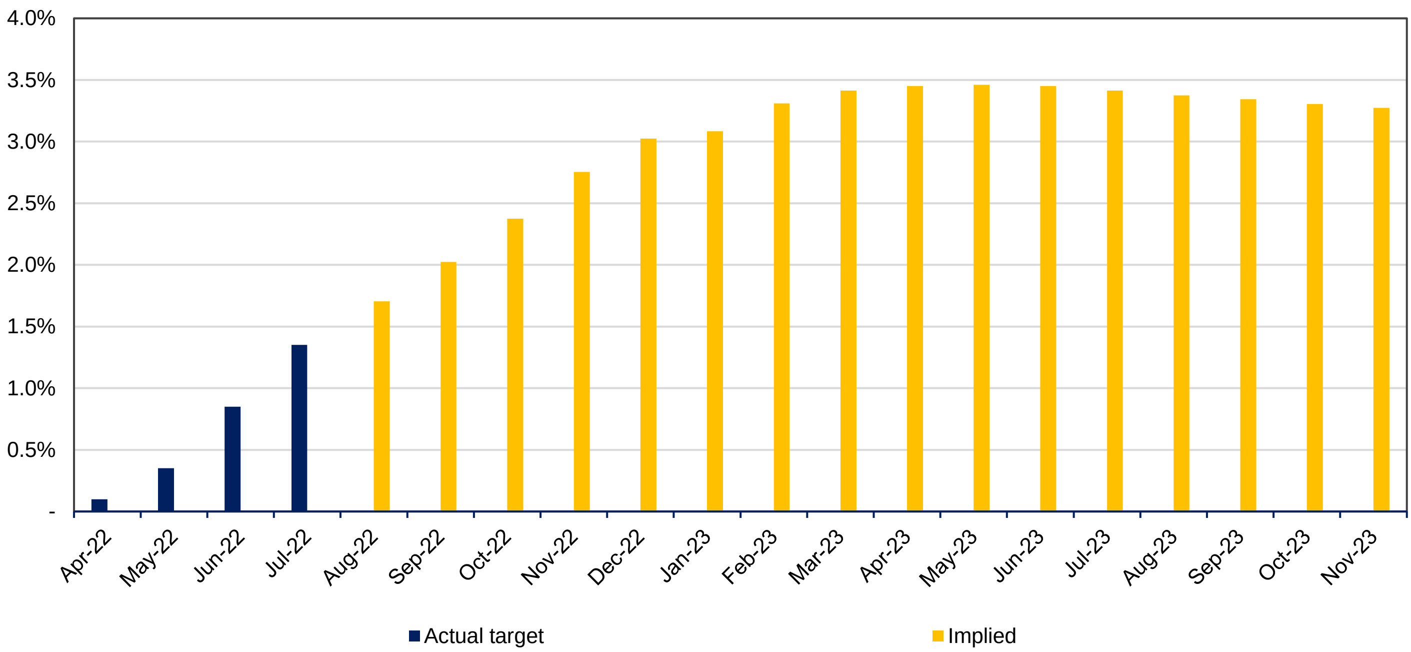
It would appear to us, based on the information above, that it is reasonable to expect that many of the inflationary pressures that are currently driving global inflation are likely to abate over the coming year. This is not premised on forecasting future moves in commodity prices or inflation inputs, but on the fact that current spot prices dictate that inflation is likely to ease meaningfully in the absence of another strong upward move in input prices. For inflation to stay high there would need to be continued steep price rises. This is because inflation measures the year-on-year change in the price of goods and services, not their absolute level. Falling prices actually have a deflationary impact on future inflation levels. Investing is probabilistic, and we will change our views if the facts change, but at this stage much of the inflation we have seen appears likely to subside over time.

We do not mean to suggest that inflation does not pose a significant economic or financial risk. In Australia there has been a considerable lag in inflation and the RBA expects it will peak in the final quarter of 2022 at approximately 7%. We also acknowledge the argument that higher wage claims could drive a "wage-price spiral" and that inflation expectations could be anchored at higher levels. We will continue to monitor the facts and adjust our expectations accordingly. However, we believe it presently appears that while "trimmed mean" inflation will be higher than it has been over the last decade, driven by tight labour markets and hence higher nominal wage growth, it is likely to be well below the current levels being experienced in the US, UK and many other jurisdictions.

4. Interest Rates

If inflation subsides then we anticipate that expectations for considerable interest rate increases will moderate. Current futures curves are pricing in considerable interest rate rises.

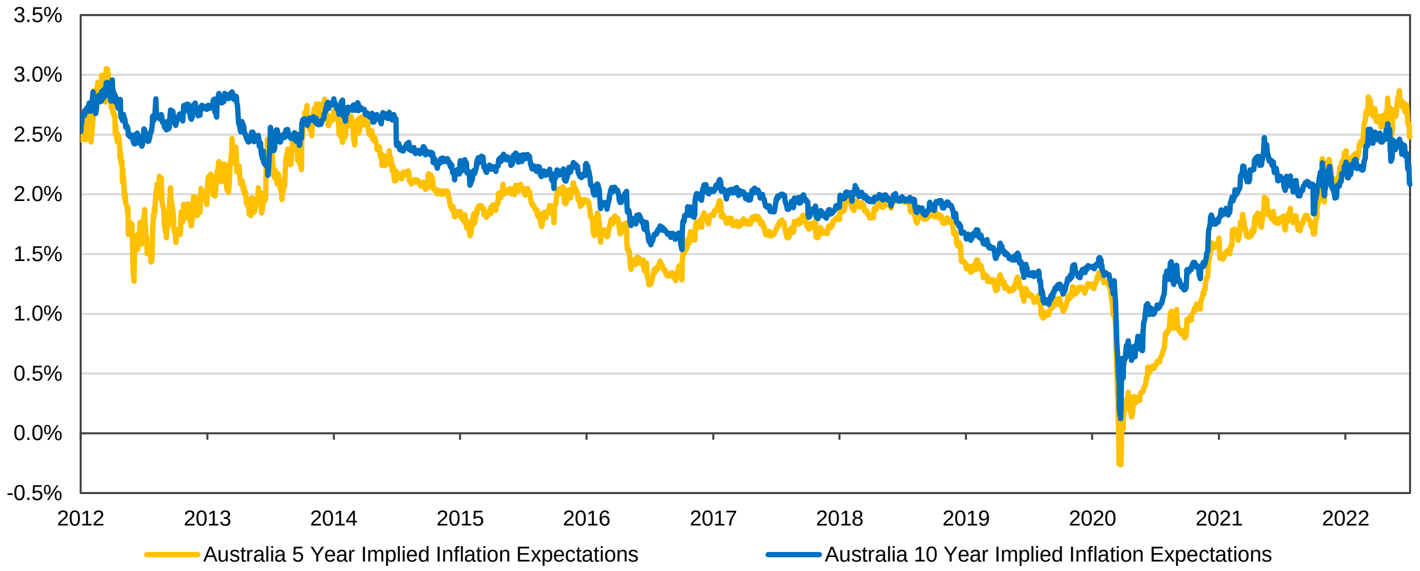
Interbank Cash Rate Futures Implied Yield Curve (%)



Source: ASX, Auscap

This would appear to be premised on the expectation that inflation will continue to run at elevated levels, albeit 5 and 10 year inflation expectations appear to have moderated recently, and are not reflecting persistently elevated inflation.

Australian Government Bond Implied Inflation Rates



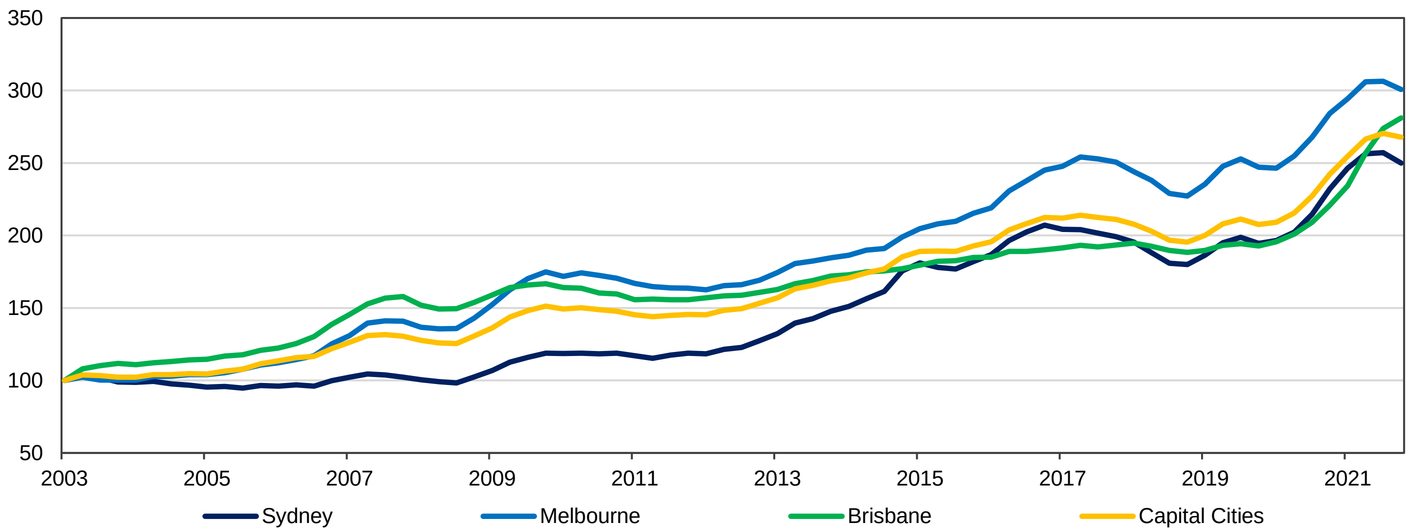
Source: ABS, Auscap

If inflation does moderate, then we anticipate that long term yields on Government bonds might retrace some of their recent upward move.

5. Recession Probabilities

If we do end up with significantly higher interest rates, will that automatically result in a recession? Higher interest rates are likely to reduce the amount households and investors are able to borrow. If this eventuates then we think it is almost certain that residential property prices will decline. We witnessed this in 2017 to 2019 when APRA-imposed lending restrictions resulted in a reduction in the availability of credit. Property markets subsequently declined between 10% to 15% in the major Australian capital cities.

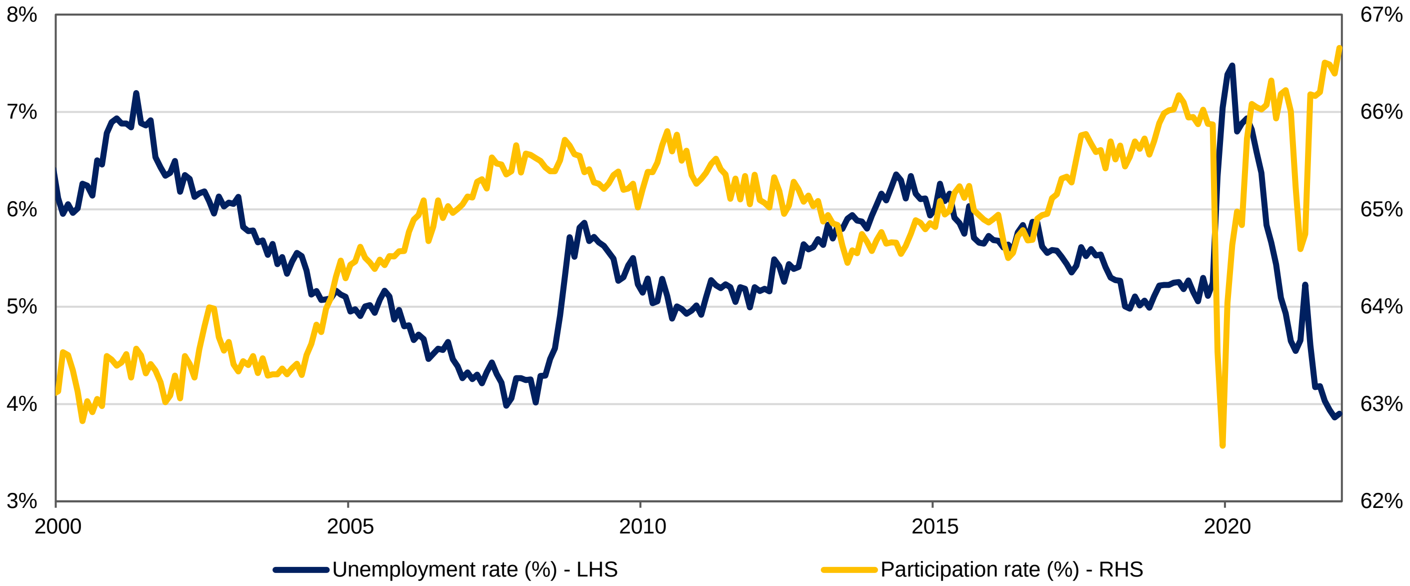
Corelogic Residential Property Price Index - Rebased to 100



Source: Corelogic, ABS, Auscap

Many market participants appear to be assuming that a decline in residential property prices would automatically result in a recession, but this was not the case in 2017 to 2019, and in many respects ignores the relative strength of the Australian economy. Australia currently has its lowest unemployment rate, at 3.9%, in at least 44 years (which is when the Australian Bureau of Statistics (ABS) started recording unemployment data). Further, the participation rate is at record levels.

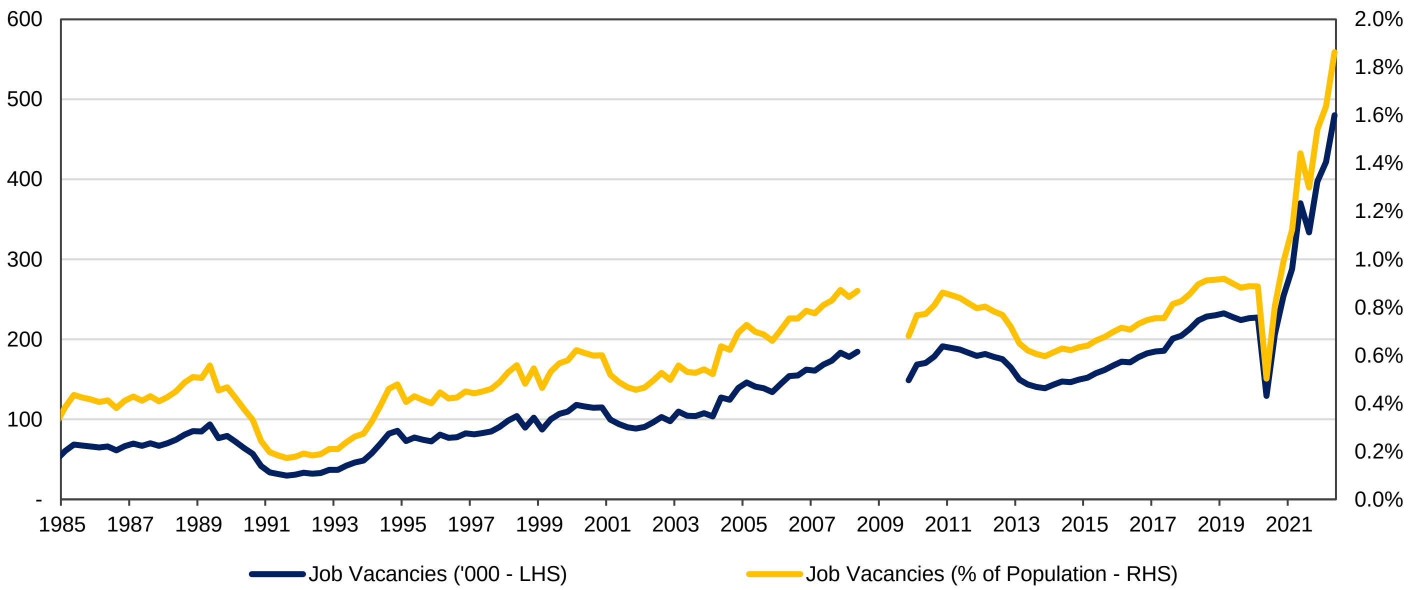
Unemployment & Participation Rate (%)



Source: ABS, Auscap

Since the ABS started recording jobs data, job vacancies in absolute terms and as a percentage of the population have never been higher.

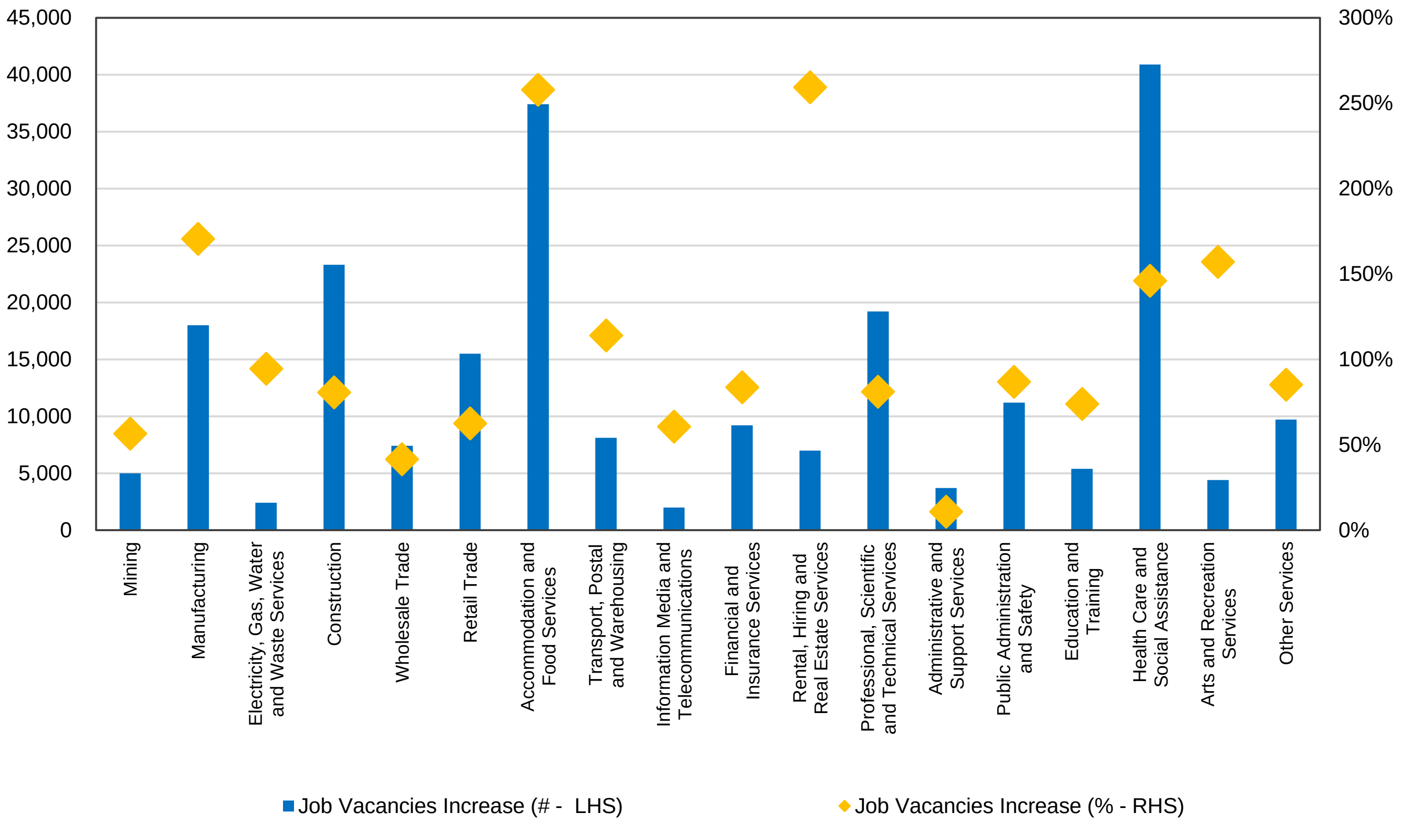
Australian Job Vacancies ('000s and %)



Source: ABS, Auscap

In fact, there are more jobs available in every single sector today than there were pre-COVID.

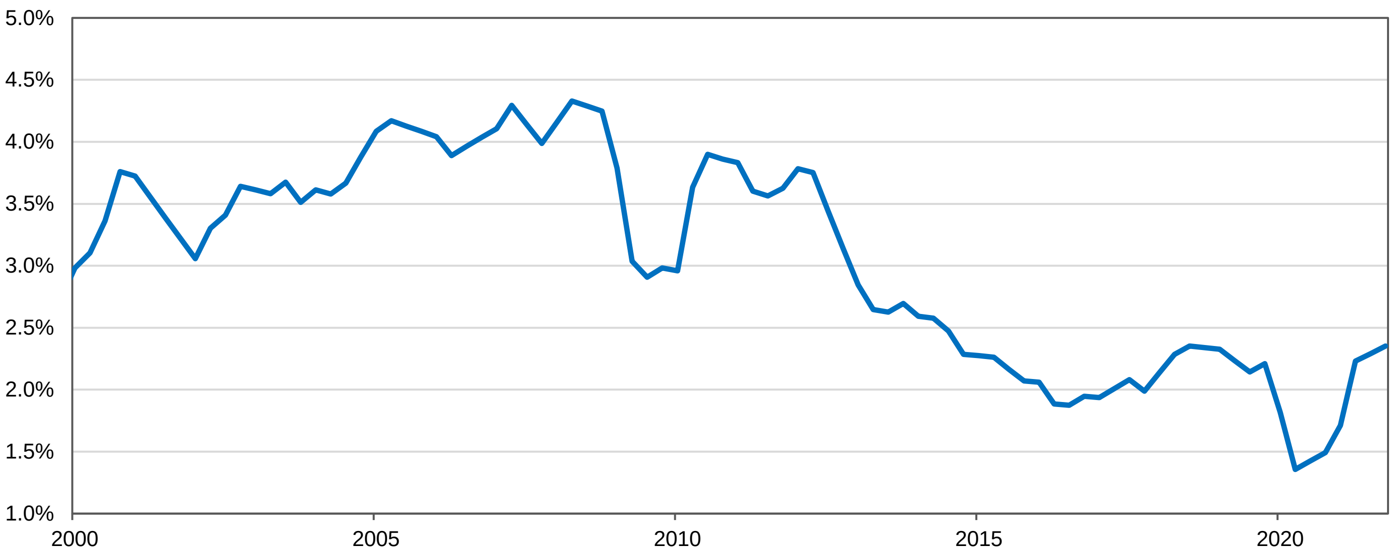
Change in Australian Job Vacancies: November 2019 to May 2022



Source: ABS, Auscap

Wage growth is accelerating, and is likely to strengthen further.

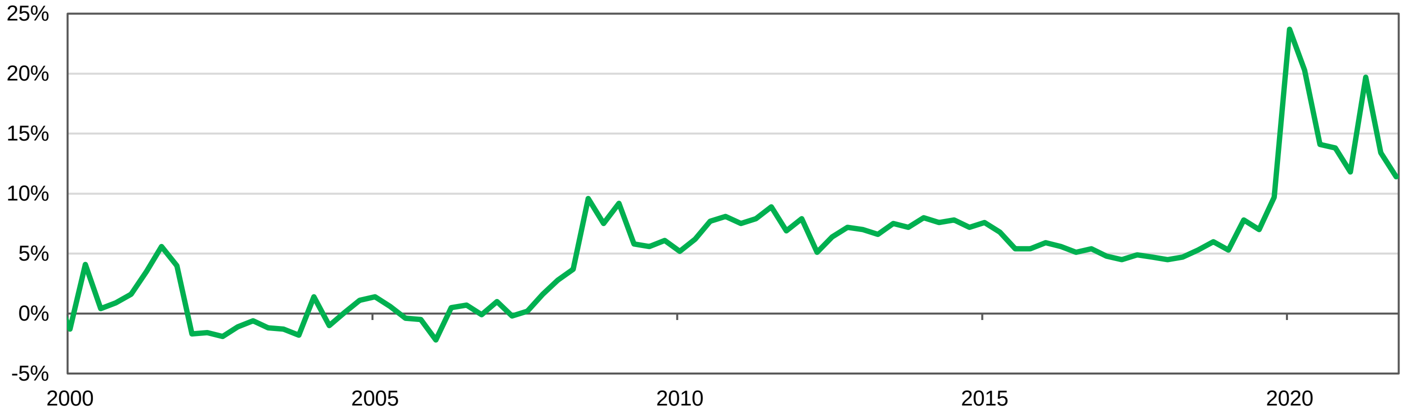
Wage Price Index growth (%)



Source: ABS, Auscap

The savings ratio remains remarkably high, giving households a significant liquidity buffer against economic shocks.

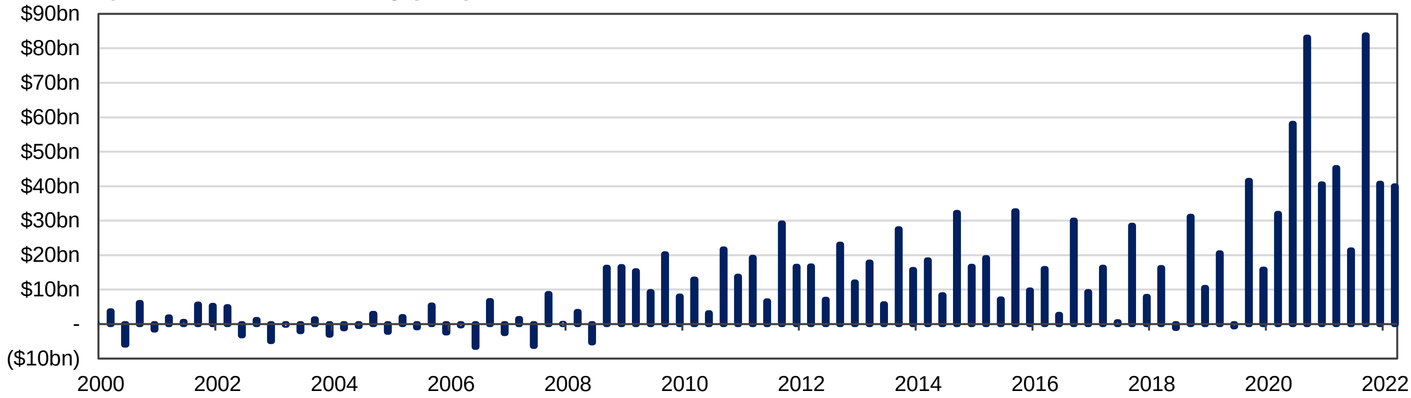
Household saving ratio (%)



Source: ABS, Auscap

Since the start of the pandemic, Australian households have saved over $412bn.

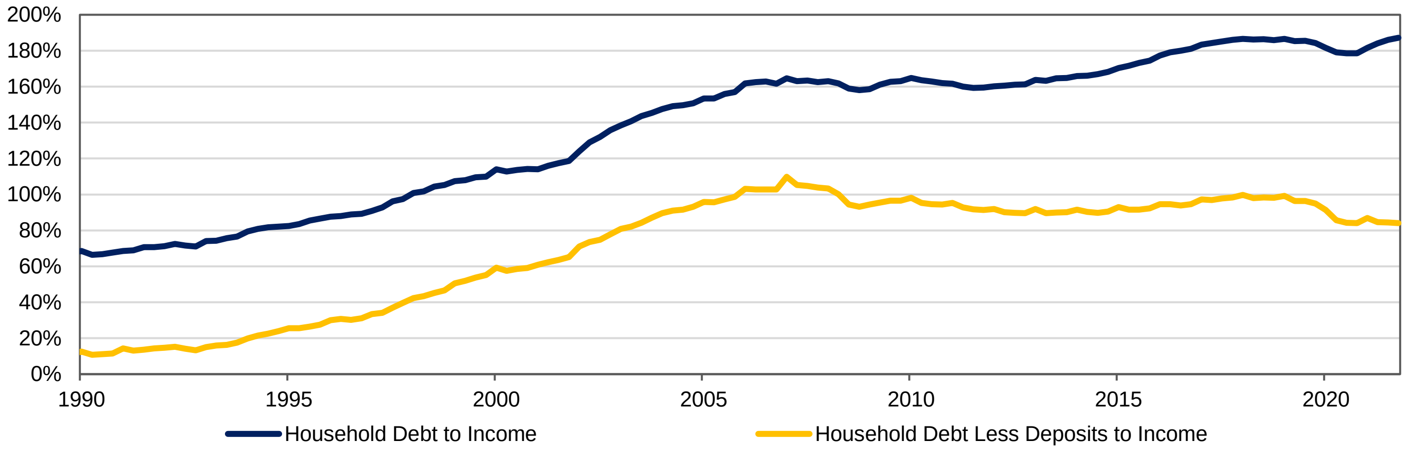
Quarterly Net Household Saving ($bn)



Source: ABS, Auscap

This has resulted in household net leverage falling to the lowest levels since 2003.

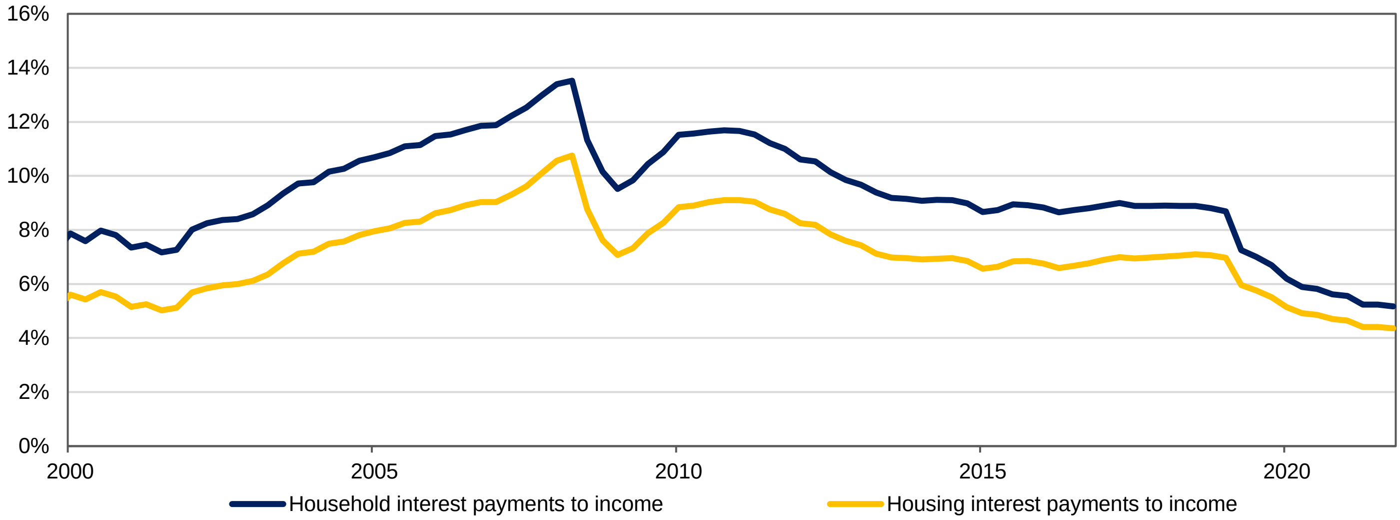
Household Debt



Source: RBA, Auscap

As a result, the percentage of disposable income that was directed towards interest payments in the March 2022 quarter, when the RBA cash rate was at 0.1%, was an all-time low of 4.4%. Assuming interest rates are quickly adjusted a further 1% higher, given the RBA has currently already lifted rates 1.25% and has indicated further hikes, and banks maintain their current borrower mortgage assessment buffers, we expect this would increase the interest expense to circa 9.4% of disposable income, roughly in line with the 20-year average of 9.5%. If this is the case, we would anticipate a similar decline in the savings rate, acknowledging that due to the distribution of borrowers there will likely also be some impact on consumer spend.

Interest payments to income (%)

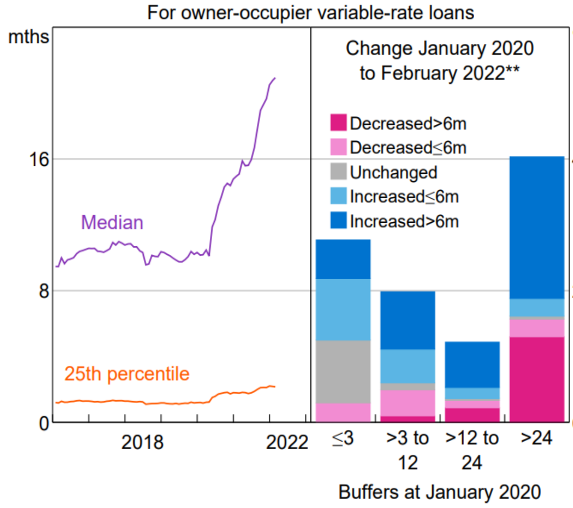


Source: RBA, Auscap

A higher RBA cash rate and hence mortgage rate definitionally reduces the ability of households to borrow. So, we believe that a higher cash rate is likely to result in lower residential property prices, reflecting a reduction in the ability of the average household to borrow to finance a purchase. However, as outlined above, households appear well positioned to manage this transition to higher rates. Further, mortgage holders are currently a long way in front of their repayment schedules, providing an additional buffer. And corporate balance sheets are broadly in a very healthy condition.

Mortgage Excess Payment Buffers*

For owner-occupier variable-rate loans



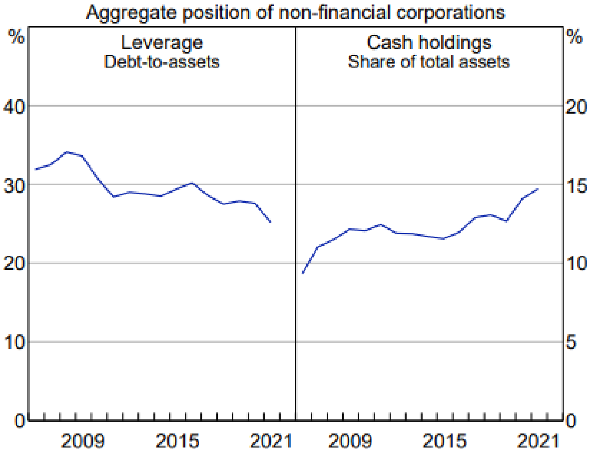
* Offset plus redraw balances; measured in months of minimum repayments; excludes split loans.

** Expressed as a share of owner-occupier variable-rate loans.

Sources: RBA; Securitisation System

Corporate Balance Sheet Health

Aggregate position of non-financial corporations

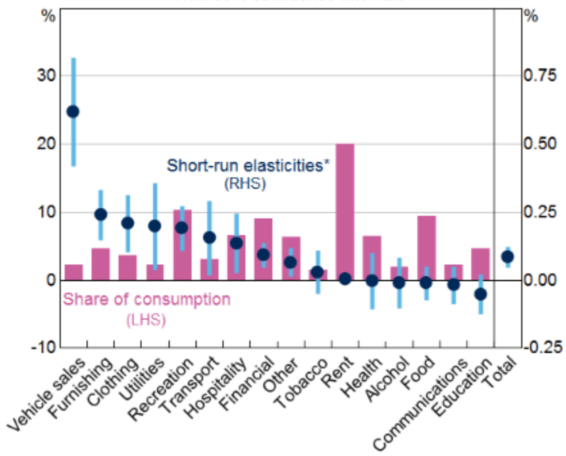


Sources: ABS; RBA

In 2017 to 2019 residential property prices fell considerably, yet the Australian economy comfortably avoided recession, due in large part to a strong employment market. Further, the RBA has analysed the effect on real consumption from falling real residential property prices. They found that there was an impact on the consumption of automobiles, with a 0.6% reduction in turnover for every 1% fall in residential property prices. However, outside of vehicle sales, the RBA found relatively little impact on consumption across the other categories that they measured. Home furnishings was the second most affected category, with a delta of 0.25, meaning a large 10% decline in property prices only implied a 2.5% decline in spend on furnishings. It is not a fait accompli that a decline in residential property prices will cause a dramatic decline in domestic consumption.

Wealth Effects by Consumption Category

With 95% confidence intervals

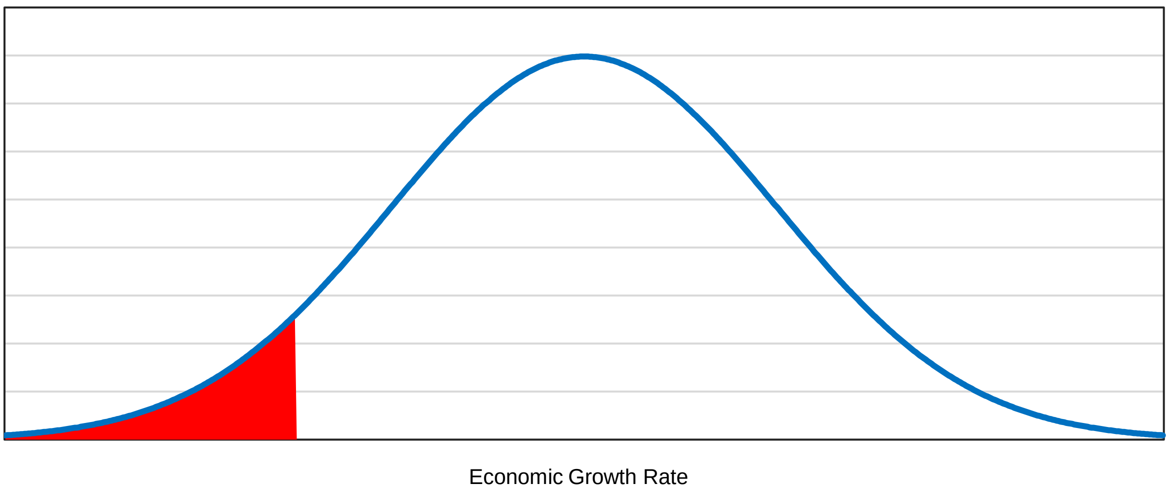


* Effects of a 1 per cent increase in per capita housing wealth over two quarters

Source: Authors' Calculations

The market appears to be pricing in a significant probability of persistent inflation, the risk of much higher interest rates, and the assumption that this will have a negative impact on household expenditure, demand and hence economic growth. There is plenty of talk of a recession, and many stocks, in particular those companies exposed to discretionary household spend, are being priced as though this outcome is inevitable. Yet to us, on the balance of probabilities, this still appears to be a left tail risk event, shown graphically by the red section in the chart below. In this context, and throughout this newsletter, we use the term “recession” in its economic sense of a general decline in economic activity, rather than in the statistical sense of a technical recession, where real GDP growth is negative because inflation spikes above nominal GDP growth over a few consecutive quarters. The prospect of a technical recession appears far more likely to us than an economic recession.

Near Term Economic Growth: Outcome Probabilities



Note: this chart is illustrative only and not intended to be representative of the probabilities associated with each outcome identified.

Invert, Always Invert!

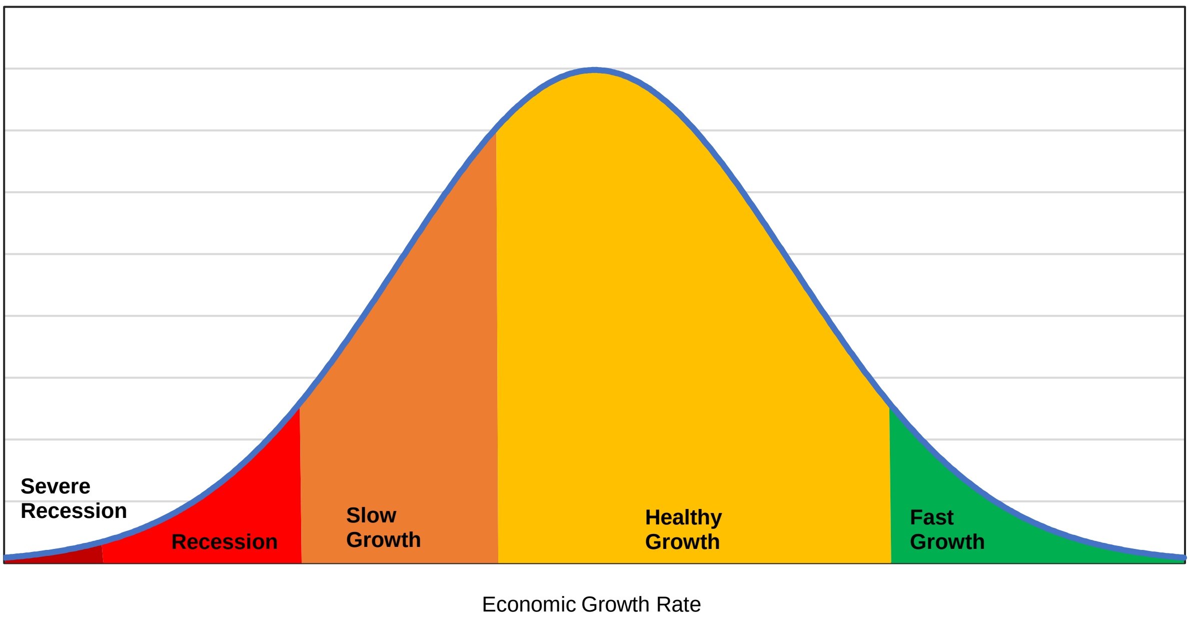
Charlie Munger has often been quoted saying the loose English translation of the German mathematician Carl Jacobi's famous phrase "*man muss immer unkehren*", or "*invert, always invert*!" We attempt to invert our thinking in relation to investing, including the present broadly-held assumption within the market that a recession is imminent.

There would appear to be a reasonable probability that many parts of inflation are transitory. There is a reasonable likelihood that interest rates do not need to go significantly higher, either because inflation starts to decline or higher interest rates curtail demand sufficiently. And, even if this is not the case, our view is that there is a reasonable prospect that households in Australia are able to financially manage higher interest rates without tipping the economy into a recession. Only one of these statements needs to be correct for the economic outcome to be substantially better than recession.

To return to our starting premise that the future is unknowable. For the reasons outlined above, we presently think that an imminent recession is still a left tail risk. In other words, unlikely in the near term, even if the odds of this occurring have risen in the last six to twelve months. If the market is pricing in a recession, and if we are comfortable with the prices that we are paying for stocks assuming as such, then presumably we are satisfied with the returns on offer should a recession occur. But, if we are also correct in our assumption about the likelihood that the majority of potential outcomes are better than a recession, then we think that the returns on offer should one of these outcomes eventuate are compelling.

Recognising when markets are extremely pessimistic can result in reasonable investment outcomes if the bearish outcome eventuates, and strong investment outcomes should things turn out better than presently anticipated. It should be acknowledged that there is also a small risk that things turn out worse than presently priced by the market, which is why this evaluation process is a continuous one. We represent these possible outcomes in the bell curve below, with a severe recession highlighted in dark red on the left side. Many companies appear to be currently priced on the assumption that a recession is going to occur.

Near Term Economic Growth: Outcome Probabilities



Note: this chart is illustrative only and not intended to be representative of the probabilities associated with each outcome identified.

6. Characteristics of the Fund's Portfolio

We view the Fund's portfolio as high quality, demonstrated by its high weighted average historic return on equity, attractively priced and with strong forecast earnings growth. The sell-off over the last six months has provided an attractive time to deploy surplus capital to add to some existing positions, increasing the overall quality of the portfolio, and to buy into businesses that we find attractive but the Fund did not previously own. At present, the portfolio has the following characteristics according to analyst consensus forecasts.

	FY23 P/E (x)	FY21 Return on Equity (%)	FY22-24 Forecast EPS Growth (%)
Auscap Long Short Australian Equities Fund	14.6x	29.6%	16.0%
All Ordinaries Index	12.8x	13.0%	4.6%

Source: FactSet analyst consensus as at 4 July 2022.

It is worth noting that we are more optimistic in our own internal forecasts than the broader market on the earnings for many of the stocks that the Fund owns. However, even assuming analyst consensus forecasts, we believe it is clear that the portfolio is higher quality than the broader market, has more compelling earnings growth in the near term and is priced at a modest premium to the Index, most likely reflective of the impact of higher energy and resource company weightings in the Index, which typically trade on a lower multiple of earnings.

7. Recent Changes to the Fund's Portfolio

We have taken advantage of the recent sell-off to make a number of changes to optimise the portfolio. We exited Unibail-Rodamco-Westfield (Unibail) on concerns that substantially higher long term Government bond yields will reduce the relative attraction of commercial real estate. To put this in context, the net initial yield for Unibail's portfolio valuation at 31 December 2021 was 4.6%. At one stage during June 2022, the yield on a 10-year Australian Government bond was 4.25%, up from just over 1% a year before. So, the relative attraction of Unibail declined, reflected in the collapse of the yield spread between what the company offered and what you could receive risk free from Australian Government bonds. We viewed this investment as the Fund's biggest risk exposure to higher interest rates.

We have bought small positions in electrical appliance maker Breville, building product manufacturer James Hardie and platform operator HUB24. We have also added to some of the Fund's existing holdings where we saw compelling value on offer.

We believe that the portfolio holds businesses that generate strong cashflows that they use to reinvest in further growth opportunities and/or payout to shareholders in the form of dividends. Most of the businesses are the most efficient operators in their market. These businesses are highly likely to benefit compared to peers if we do remain in a higher inflation environment because operators with a lower cost of doing business than their competitors can leverage their position to either take market share and/or increase their margins. The Fund remains fully invested and we are optimistic about the portfolio investments.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
June 2022	(11.8%)	(9.4%)
Financial Year To Date	(13.9%)	(7.4%)
Since Inception	250.6%	118.9%
Annualised Returns	14.0%	8.5%

Fund Exposures

June 2022 Average	% NAV	Positions
Gross Long	98%	36
Gross Short	0%	0
Gross Total	98%	36
Net / Beta Adjusted Net	98%	106%

Portfolio Commentary*

The Fund returned negative 11.8% net of fees during June 2022. This compares with the All Ordinaries Accumulation Index return of negative 9.4%. The Fund's largest exposures over the month were spread across the consumer discretionary, communication services, real estate, materials and financials sectors.

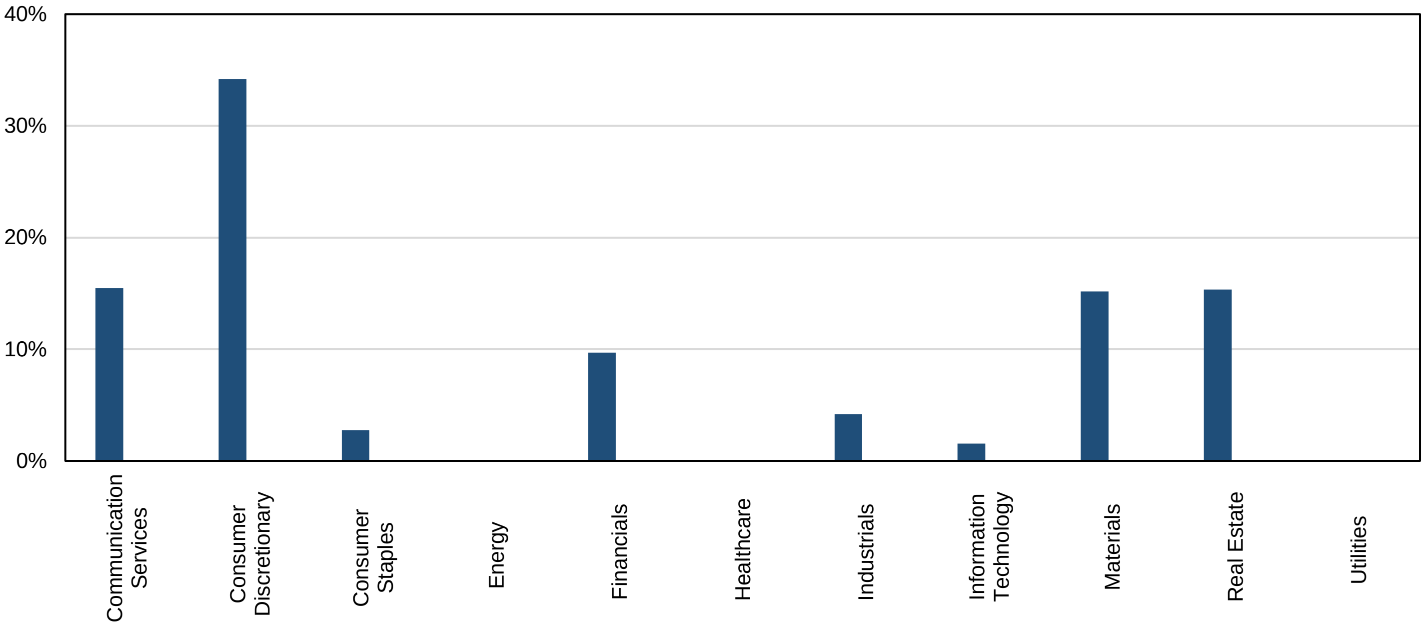
Fund Calendar Year Returns*

CY13	51.9%	CY18	(18.5%)
CY14	23.2%	CY19	18.1%
CY15	36.0%	CY20	10.6%
CY16	2.2%	CY21	43.2%
CY17	17.1%	CY22	(25.4%)

Top 20 Investments^

Adbri	Lovisa
ARB Corp	MA Financial Group
Blackmores	Macquarie Group
Carsales.com	Mineral Resources
Charter Hall Retail REIT	Motorcycle Holdings
Eagers Automotive	News Corporation
GDI Property Group	Nick Scali
HomeCo Daily Needs	NZME
JB Hi-Fi	REA Group
Jumbo Interactive	Reece

Sector Exposure - June 2022#



* *Performance figures are calculated for the Monthly Class net of all fees and expenses and assuming the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.*

^ *Top 20 long investments in alphabetical order as at 30 June 2022.*

\# *Average Sector Exposure during June 2022.*

Newsletter – July 2022

Disclaimer

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Auscap Asset Management Limited

ACN 158 929 143 AFSL 428014
Lvl 30, 9 Castlereagh St, Sydney

Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
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Tax & Audit: Ernst & Young