# Auscap Newsletter

## Auscap Long Short Australian Equities Fund

## Auscap Global Equities Fund

MARCH 2020

AUSCAP ASSET MANAGEMENT

# Coronavirus Crisis

Fear and panic have gripped markets. In the four weeks since the 21st of February the ASX200 has declined from 7197 to a low of 4402 on the 23rd of March. And there is no telling whether and by how much it might continue to fall. The 38.8% decline has been extraordinary in its ferocity and speed, only surpassed in modern Australian stockmarket history by the 1987 crash. The magnitude of the moves at the stock levels are even more dramatic. The resilience of some big index weights, including Woolworths, Coles and CSL, masks the destruction in valuations elsewhere in the index. Many stocks are down well over 50% in just four weeks. There has been very little time to modify investment exposures to respond to new information. The positive outlook for the domestic economy, highlighted by the better than expected fourth quarter 2019 GDP data released on the 4th of March, has been made irrelevant by the probability that growth will be significantly negative in the coming months as countries shut down to reduce the loss of life stemming from the coronavirus COVID-19 (*Coronavirus*). So the question from here is what to do now? Is it a time to be selling or buying?

**ASX200 Performance: 2010 - 2020**


In relation to whether now is the time to sell, the critical factor is whether the value of the companies that an investor owns has changed in the last four weeks by the degree to which the share prices have moved. At a high level, the economic impact of the coronavirus on most companies will last the duration of the period in which it is not under control. During this period the hit to GDP, company revenues and earnings will be potentially enormous.

We do not wish to add to the sensationalism of every current headline, but clearly the travel, tourism, services, education, media, consumer discretionary and banking sectors are likely to be heavily impacted. In this regard the government is taking a proactive approach. If income is lost due to policies aimed at implementing social distancing and, for those potentially or actually infected, self-isolation, then the government needs to provide these individuals and small businesses with cash to be able to carry on through this period. This is exactly what the Australian federal and state governments are undertaking to do.

Similarly, there is likely to be a rise in unemployment, potentially substantial. However, these jobs are unlikely to be lost forever. It could be reasonably expected that the same number of waiters, hairdressers, event planners and tour guides will be needed post Coronavirus. There may be a sharp "recession", but it seems likely that there will be a significant rebound in activity thereafter, absent the crisis cascading into something else altogether.

With more of the world's medical resources devoted to working on both a vaccine and antiviral medication for the Coronavirus than, we suspect, any other virus in history, we believe it is right to be optimistic about the likelihood of medical success over the next 6 to 12 months. Australia is also acting quickly to try to stem the spread of the disease. Testing is an important part of this process, to let infected people know they are infected so that they can self-isolate to reduce the risk of infecting others. Testing rates per capita in Australia are among the highest in the world.

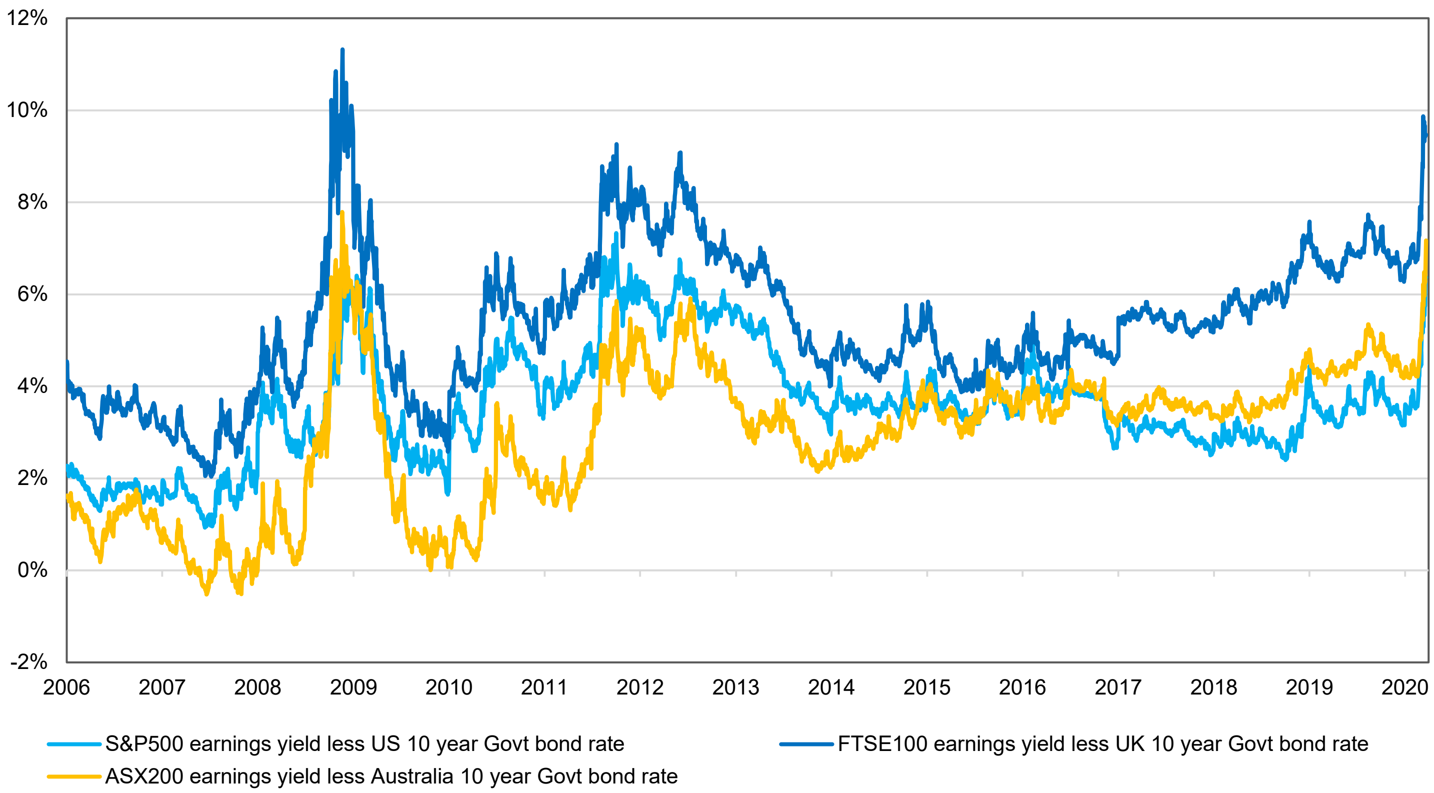
So how do we think about the valuation of companies to incorporate the impact from the Coronavirus? The businesses we own are conservatively geared, generally best of breed operators that are well placed to weather a difficult period. Each business will be impacted in different ways, and it is important that we assess this. Almost every company will experience a decline in earnings in the near term. Generally the market responds aggressively to earnings downgrades because the current year's earnings are typically the most reliable baseline for assessing future years' earnings. So typically a 30% earnings deterioration this year might justify a 30% deterioration in the valuation of the company, as analysts reassess and lower expectations for all future years of earnings.

However, it is most likely that the Coronavirus will not have an ongoing effect. The impact is more likely to be a genuine one-off occurrence. Even if all of the businesses we own collectively make no money for the next 6 months, some will even lose money, the earnings thereafter should return to a level similar to what they were prior to the Coronavirus. (In fact for many, pent up demand could result in a short spike above previous levels post resolution of the crisis.) Put another way, owning stocks now is akin to owning them in 6 or 12 months time, or however long a resolution takes, when earnings will be back to normal at extremely attractive valuations while accepting that there might not have been any earnings to speak of in the interim, and there may even be some one off costs or losses to factor in.

This said, the market may continue to fall. However, most people that sell now assume they will know when to get back in. This is virtually impossible. There is no bell that chimes when the stockmarket low has been set. The pain may continue for some time, but as previous dislocations have demonstrated, often the market starts to climb the wall of worry while the news is still bad. By the time the recovery comes stocks have often rebounded considerably.

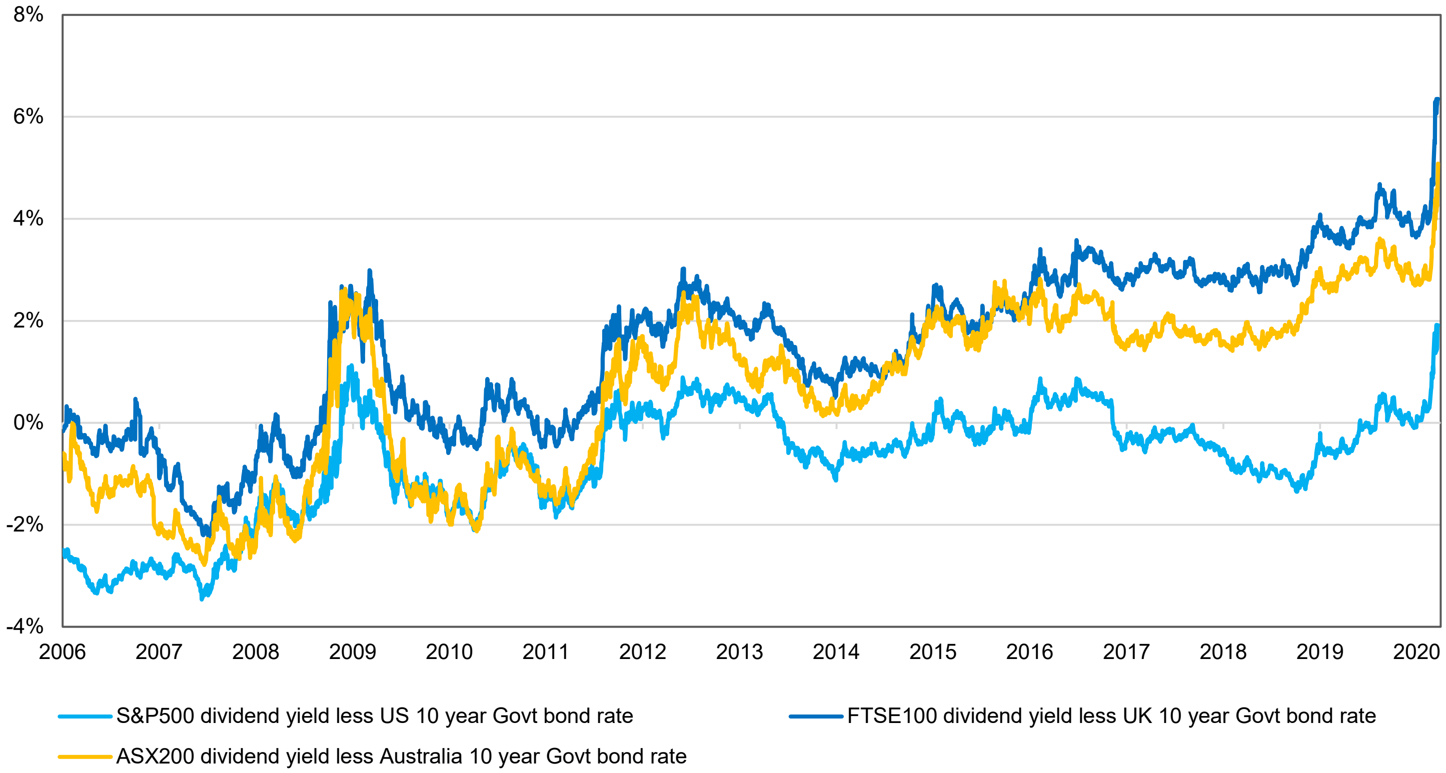
So when is the time to buy? This is a difficult question to answer. Implied equity risk premiums are extremely wide, as shown below. However, as a frame of reference, they are not yet at the same level as the peak of the Global Financial Crisis.

**Implied Equity Risk Premiums**



Equity yield premiums, or the additional yield you are likely to receive for holding shares over Australian Government bonds, have never been higher.

**Equity Yield Premiums**




While there is undoubtedly risk to near term dividends, lost dividends should be reinstated in most instances post the resolution of Coronavirus concerns. Again, analysing each company and assessing the risk to dividends is important. Interestingly, we closely follow buying and selling activity from those inside the company. Directors and management know far more about the businesses than an external investor will ever know. So they are in a more informed position to make a decision about the long term prospects of the business. During difficult periods, they are best placed to understand whether the company can weather the storm. If they are committing their own after-tax income to buy shares, it is normally a good indicator that there is value on offer. In the last 4 weeks we have had insider buying, typically from directors, in 13 of the 27 companies the Auscap Long Short Australian Equities Fund is presently invested in. This is the highest ratio we have ever seen in a short period of time.

What if you were already caught long, as we were, and do not therefore want to add to your overall exposure? At this stage portfolio optimisation appears to be the best approach to preparing for an eventual recovery in asset prices. Portfolio optimisation might involve selling some assets, even if they have fallen, to buy other assets at even more attractive prices. So far the virus has had quite a different effect on valuation depending on the company, throwing up opportunities. This is the time to improve the quality of and prospective returns from a portfolio. Reducing an investment, even in a stock that is undoubtedly cheap, to buy part of a better business at a more compelling price, is a logical exercise at this point and one we are endeavouring to undertake. The declines in many instances have been indiscriminate, but the recovery will not be. The best companies will outperform in the aftermath of a crisis.

We are experiencing the same raw emotion that all investors are currently going through. The market has been caught in a wave of fear about the unknown. Relentless selling has, temporarily, rendered normal fundamental valuation redundant. However, our role is to remain rational. Portfolio optimisation is a path to improving the quality of the portfolio before the eventual recovery. Until then stock market moves will most likely remain extreme, testing the resolve of every investor, both retail and professional. We encourage all investors to think long term about the companies and funds they are invested in. It is highly unlikely that the “value” of the businesses they part-own has changed to anywhere near the same degree as the recent price fluctuations as a result of the outbreak of the Coronavirus would suggest.

# Auscap Long Short Australian Equities Fund

## Fund Performance*

| Period | Auscap | All Ords |
|---|---|---|
| February 2020 | (8.2)% | (8.1)% |
| Financial Year To Date | 0.9% | (0.3)% |
| Since Inception | 173.7% | 94.8% |
| Annualised Returns | 14.9% | 9.6% |

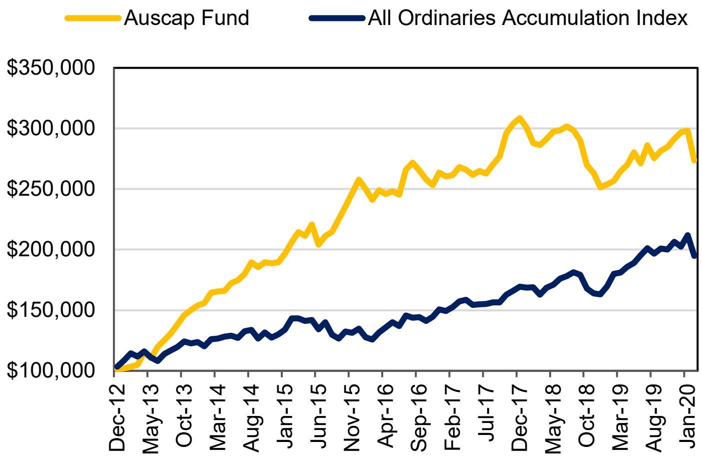
## Fund Exposures

| February 2020 Average | % NAV | Positions |
|---|---|---|
| Gross Long | 125.4% | 30 |
| Gross Short | 16.9% | 8 |
| Gross Total | 141.3% | 38 |
| Net / Beta Adjusted Net | 108.5% | 102.0% |

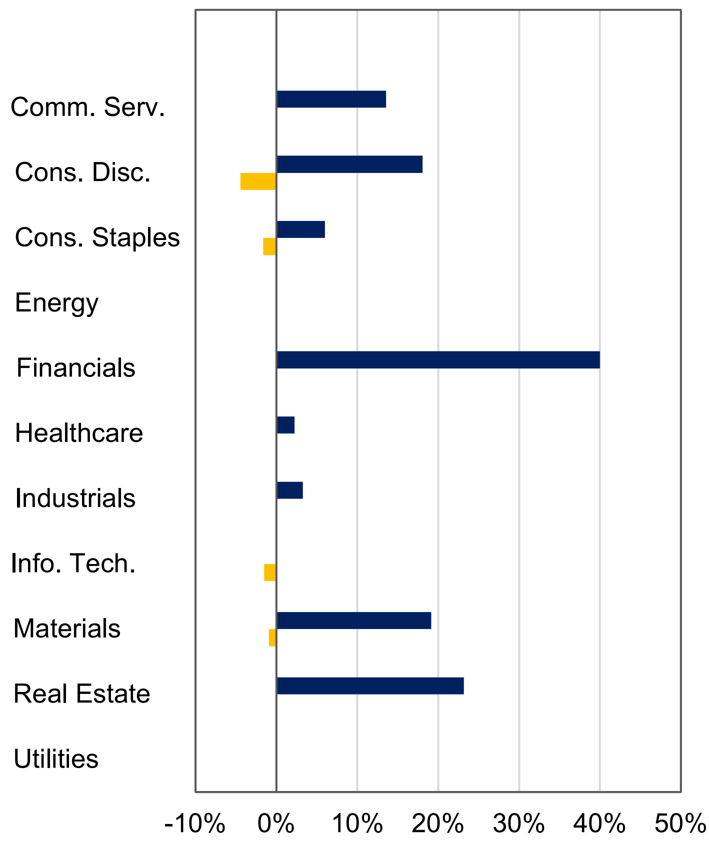
## Portfolio Commentary

The Fund returned negative 8.2% net of fees during February 2020. This compares with the All Ordinaries Accumulation Index return of negative 8.1%. Average gross capital employed by the Fund was 125.4% long and 16.9% short. Average net exposure over the month was 141.3%. Over the month the Fund had on average 30 long positions and 8 short positions. The Fund's biggest stock exposures at month end were spread across the financials, real estate, materials, consumer discretionary and communication services sectors.

## Fund Performance*




## Sector Exposure - February 2020




## Fund Financial Year Returns*

| | | | |
|---|---|---|---|
| FY13 | 19.7% | FY18 | 12.7% |
| FY14 | 46.0% | FY19 | (9.2%) |
| FY15 | 16.8% | FY20 (YTD) | 0.9% |
| FY16 | 20.1% | CY19 | 18.1% |
| FY17 | 8.0% | CY20 (YTD) | (7.8)% |

## 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 29 February 2020.*

# Auscap Global Equities Fund

## Fund Performance*

| Period | Auscap | MSCI^ |
|---|---|---|
| February 2020 | (10.1)% | (8.4)% |
| Financial Year To Date | (8.4)% | (3.7)% |
| Since Inception (Nov19) | (8.4)% | (3.7)% |
| | | |

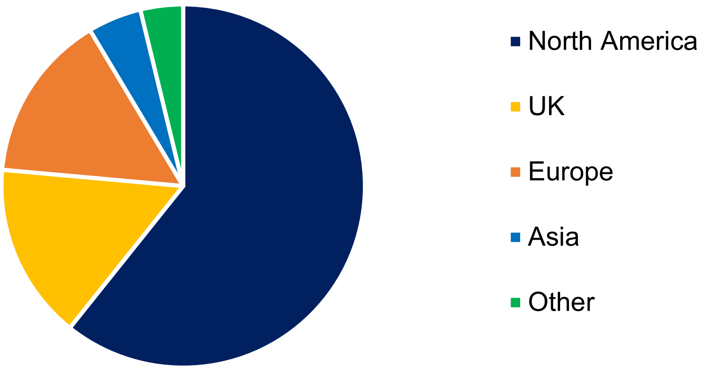
## Fund Exposures

| February 2020 Average | % NAV | Positions |
|---|---|---|
| Gross Long | 106.8% | 41 |
| Gross Short | 0.0% | 0 |
| Gross Total | 106.8% | 41 |
| Net / Beta Adjusted Net | 106.8% | 111.2% |

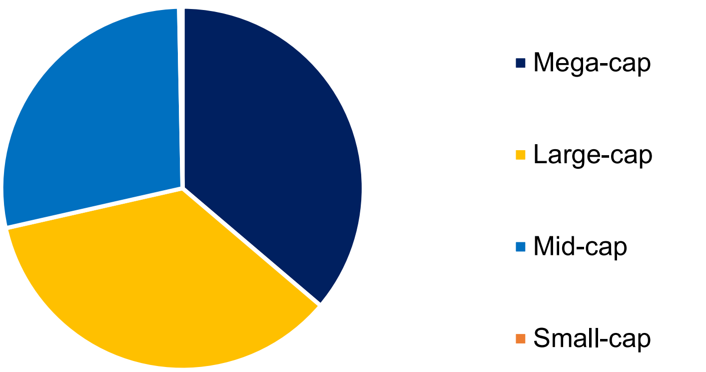
## Portfolio Commentary

The Fund returned (10.1)% net of fees during February 2020. This compares with the MSCI World 100% Hedged to AUD Index return of (8.4)%. Average gross capital employed by the Fund was 106.8% long and 0.0% short. Average net exposure over the month was 106.8%. Over the month the Fund had on average 41 long positions. The Fund's biggest exposures at month end were in the financials, industrials, consumer discretionary, real estate and information technology sectors.

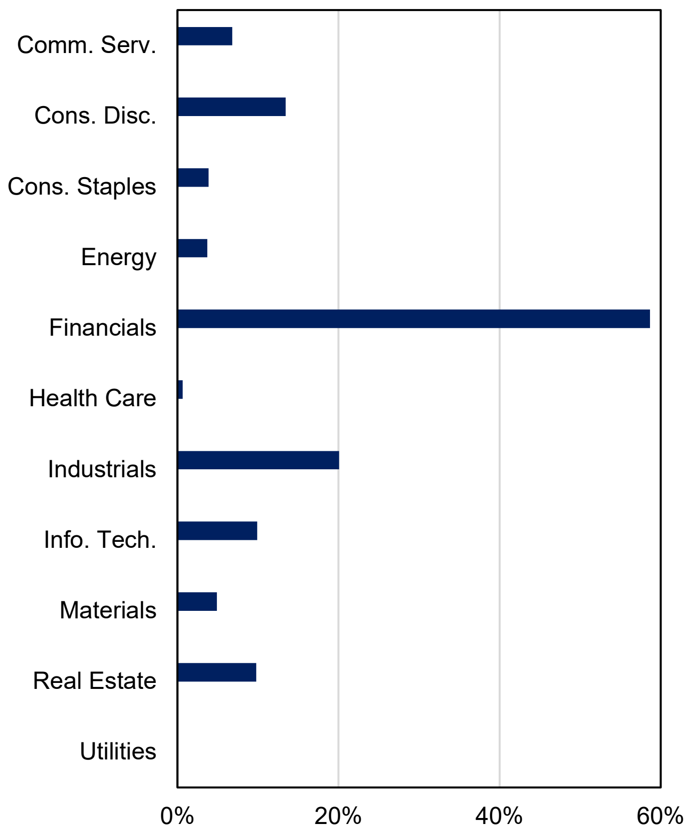
## Exposure by Region




## Exposure by Company Size




## Sector Exposure - February 2020




## Top 10 Investments+

| | |
|---|---|
| Alphabet | Intercontinental Exchange IN |
| American Express | Lloyds Banking Group |
| Canadian Natl Railway | Macquarie Infrastructure |
| Capri Holdings | Morgan Stanley |
| Citigroup Inc | Unibail-Rodamco-Westfield |

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*^ MSCI World 100% Hedged to AUD Index*
*+ Top 10 long investments in alphabetical order as at 29 February 2020.*

*Disclaimer*

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