Auscap Long Short Australian Equities Fund

Newsletter – August 2019

Fund Performance*

Period	Auscap	All Ords
July 2019	5.5%	3.0%
Financial Year To Date	5.5%	3.0%
Since Inception	186.0%	101.2%
Annualised Returns	17.1%	11.1%

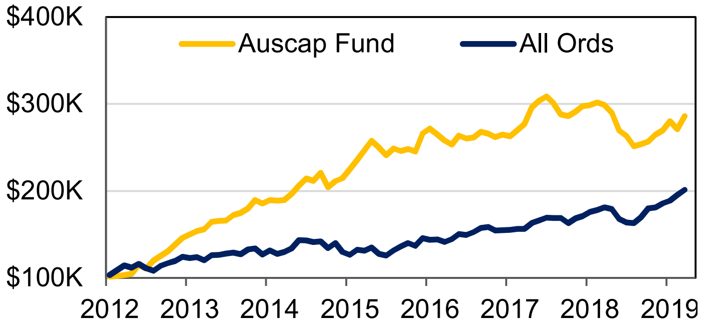
Fund Exposures

July 2019 Average	% NAV	Positions
Gross Long	124.8%	38
Gross Short	12.2%	9
Gross Total	137.0%	47
Net / Beta Adjusted Net	112.6%	96.6%

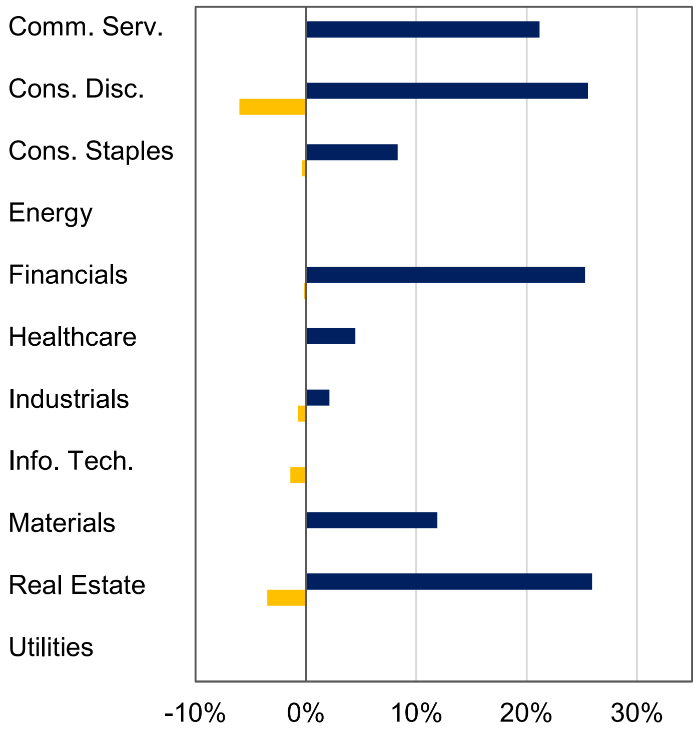
Portfolio Commentary

The Fund returned 5.5% net of fees during July 2019. This compares with the All Ordinaries Accumulation Index return of 3.0%. Average gross capital employed by the Fund was 124.8% long and 12.2% short. Average net exposure over the month was 112.6%. Over the month the Fund had on average 38 long positions and 9 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, consumer, financials, communication services and materials sectors.

Fund Performance*



Sector Exposure - July 2019



Fund Financial Year Returns*

FY13	19.7%	FY18	12.7%
FY14	46.0%	FY19	(9.2%)
FY15	16.8%	FY20 (YTD)	5.5%
FY16	20.1%	CY19	13.7%
FY17	8.0%		

Top 10 Investments^

Blackmores	Macquarie Group
Centuria Metropolitan REIT	Mineral Resources
CYBG	Nine Entertainment
GDI Property Group	Super Retail Group
JB Hi-Fi	Unibail-Rodamco-Westfield

** 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 July 2019.

Analysing FY19 Fund Returns

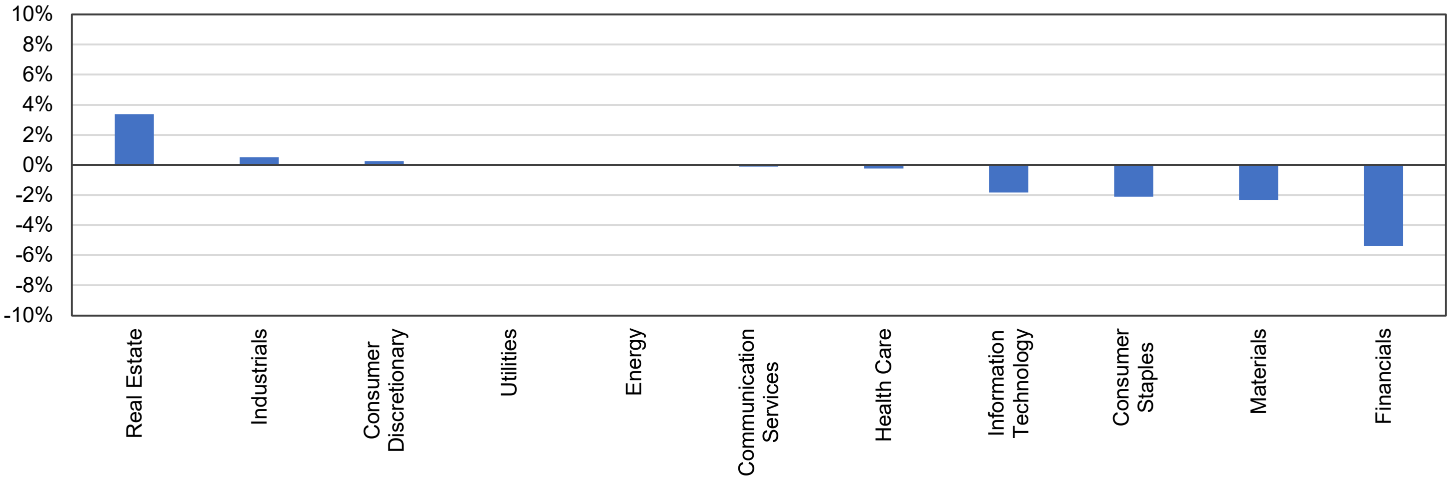
As long term investors and readers of this newsletter know, we use the August newsletter to provide a candid assessment of the Fund's performance in the prior financial year and lessons learnt or reiterated. The Fund delivered negative 9.17% net to investors during FY19. It was the first year of negative performance since the Fund launched in 2012.

The past year was characterised by the following features:

- A disappointing overall performance, largely resulting from:
  - The absence of any significant positive outperformers in the portfolio over the year.
  - A de-rating in some of the Fund's long term holdings despite continued solid performance in the underlying businesses and attractive valuations. We are firmly of the opinion that fundamentals determine valuation in the long run even if investor sentiment can be very powerful in the short term. To provide an example, so far in 2019 JB Hi-Fi has delivered a record half year result and a record full year result. Yet leading into these results the stock suffered declines over the course of 2017 and 2018 due to negative sentiment in relation to the consumer and the entrance of Amazon into the market. Sentiment can be a powerful force in determining share prices in the short term, even during periods when we are confident in the performance of the underlying business.
  - Negative performance in some of the Fund's long term holdings due to weaker short term economic trends. For instance, Mineral Resources has exposure to lithium, a market which is currently experiencing excess supply, despite strong long term demand fundamentals. The current valuation, in our view, excessively discounts the long term fundamentals and over emphasises the near-term lithium price weakness. We remain confident in the ability of management and the business to generate strong shareholder returns over the economic cycle.
  - A small number of individual positions moving against the Fund where the circumstances have changed and we have re-evaluated our exposure and either reduced or exited the position. We discuss our learnings from the year later in the newsletter. It also includes a number of shorts where valuations were extreme and fundamentals weak but the positions were closed to mitigate risk as stock prices continued to appreciate. We continue to monitor these companies and sectors.
- At the sector level:
  - Positive contributions from the Fund's overweight exposure to Australian real estate investment trusts and industrial companies.
  - Negative contributions from the Fund's exposure to financials, materials, consumer staples and information technology.
- Within equities markets, continued underperformance of value as a strategy compared to growth. We are confident that this trend will reverse at some point, given the extreme valuation metrics of many growth companies and the comparative and absolute value in many other stocks, however we have no special insight into when this will occur. Our efforts do not focus on trying to predict this turning point, but rather on owning a selection of businesses that are trading at prices that we find attractive that we wish to hold for the long term.

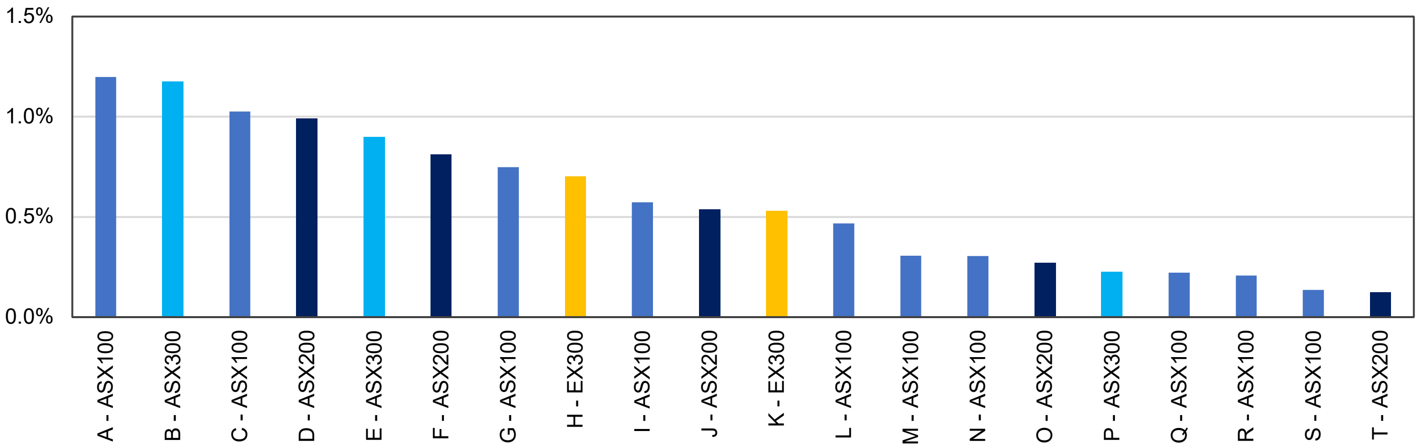
The Fund's exposures are always a function of our conviction in the companies we are invested in and their ability to deliver an attractive positive total return to shareholders over time. While the Fund typically has a majority exposure to large and mid capitalisation stocks, over its life the Fund has had a significant underweight exposure to the megacaps in the ASX20. Many of the ASX20 companies outperformed from a share price perspective in the financial year just gone, aided by the flow of passive capital into the market. The ASX20 constitutes over 51% of the All Ordinaries Index by market capitalisation. Relative performance was heavily impacted by this underweight exposure.

Gross Fund Returns by Sector



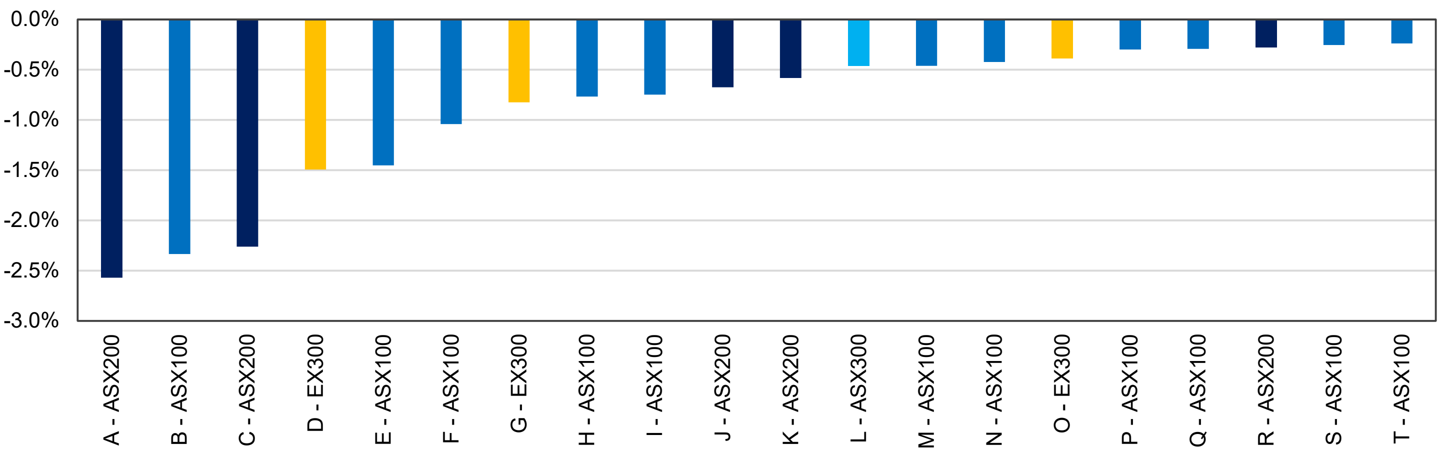
At the stock level, while there was a solid performance from a number of long positions in the Fund, there was a noted absence of any exceptionally strong performers in the portfolio over the course of the financial year.

Best 20 Single Stock Contributions to Gross Fund Performance



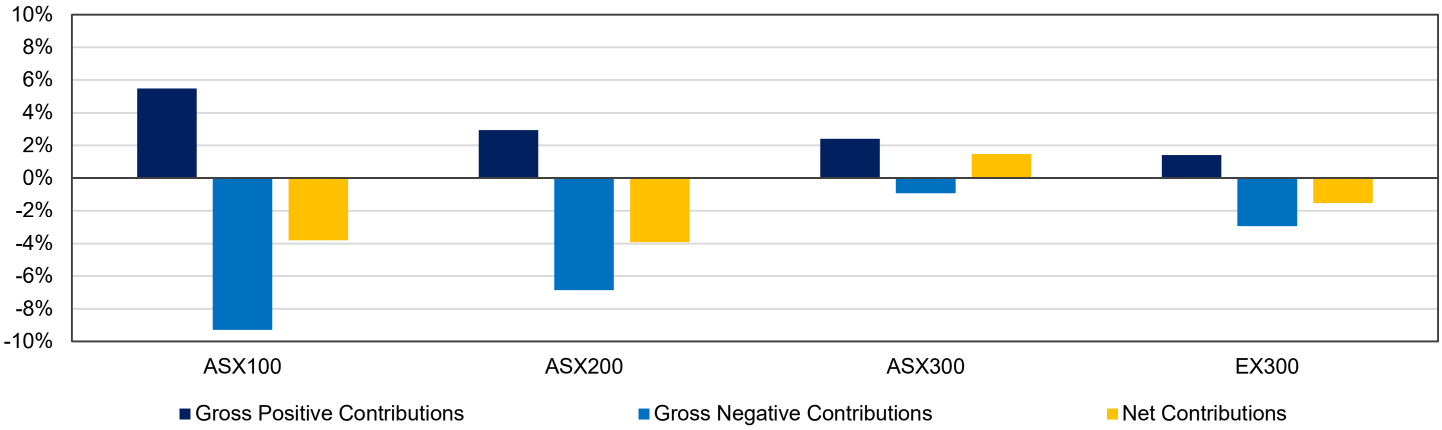
On the flipside, negative annual returns from a higher than usual number of companies, many of which have been long term positive return generating positions in the Fund, impacted performance over the course of the year.

Worst 20 Single Stock Contributions to Gross Fund Performance



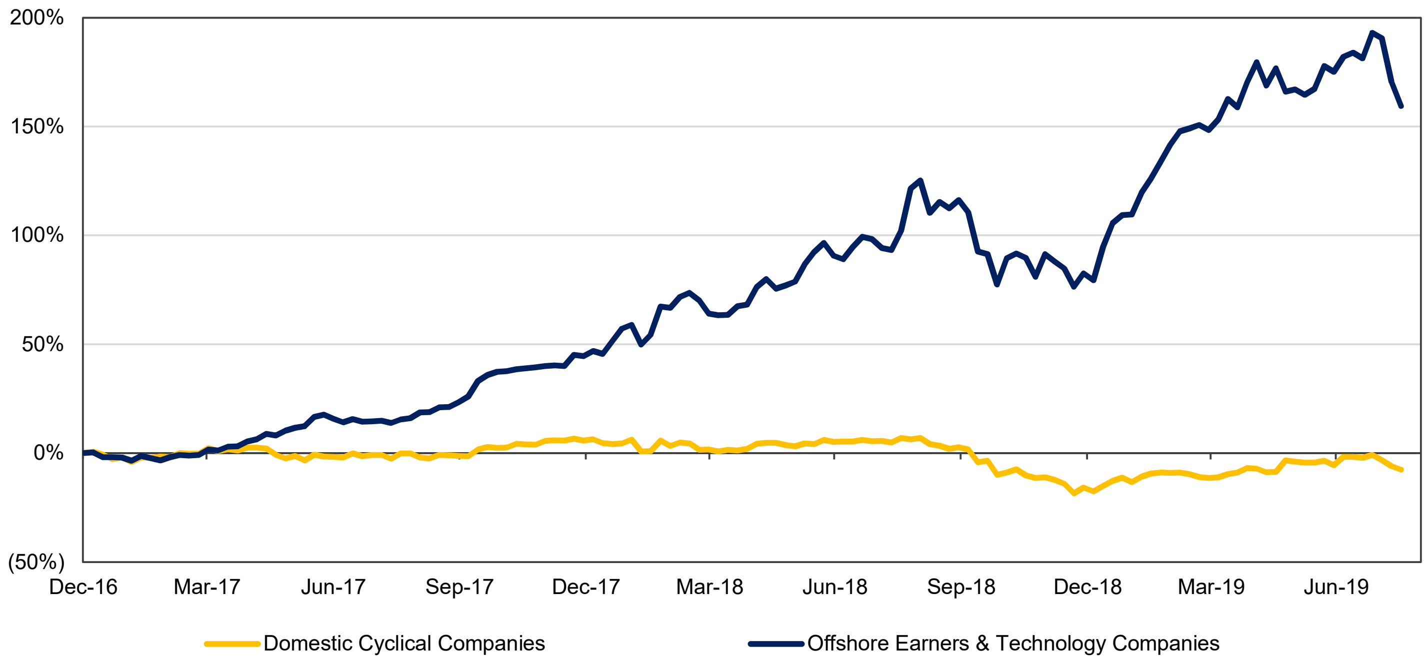
The Fund has a significant exposure to mid and large capitalisation companies, many of which underperformed in FY19.

Gross Fund Returns by Index



A value-based approach to investing has proved challenging in recent years. In Australia, one way of viewing the growth-value divide is to look at whether companies appear to have growth that is independent of the Australian economic cycle on the one hand (growth) or not (value). We represent this below by taking the simple average performance of the companies we identified within the ASX200 as either "offshore earners" or "technology" growth companies (31 companies) and compared this with the companies we identified as "domestic cyclical" value businesses (36 companies).

ASX 200 Thematic Performance - Rebased Simple Average



Source: Auscap, Bloomberg

The "growth" companies as a group have a simple average performance of over 150% since 1 January 2017. The domestic cyclical businesses, which include banking, retail, media, building and construction and property development companies, are down approximately 7%. Part of this dispersion is due to the relative differences in the companies' growth in earnings, but a more significant part has been the increasing difference in earnings multiples paid for these two groups of companies, reflective of the weight of money chasing perceived high growth businesses. While we have no insight into when this will normalise, paying ever increasing prices for businesses, even allowing for the attractiveness of those businesses, is in our opinion likely to lead to a significant risk to capital at some point.

Investing is frequently a humbling experience. As always, we reflect on the lessons learnt or relearnt over the last year:

- If earnings are likely to decline in the near term, reduce the size of the position. Share prices rarely rise when earnings are falling, irrespective of valuation. Declining earnings can create the environment for a value trap.

- In the short term, markets frequently react to changes in sentiment irrespective of valuation. If negative sentiment is likely to increase in relation to the market, a sector or a particular stock then it is worth considering reducing any relevant exposure.

- Pay less attention to what management say and more to what they do. Unfortunately the year was full of management statements to analysts about the performance of a business that did not reconcile with subsequent announcements regarding earnings.

- Be especially cautious of shorting companies where investors and speculators have come up with "valuation techniques" that enable them to ignore the constraints of traditional and accepted valuation methodologies. Under these circumstances there are no limits to where the company's share prices can rise or to the market capitalisation values such prices imply. In FY19, references to multiples of revenue, lifetime value and discussions of total addressable market featured prominently, despite none of these metrics reflecting cash flow to shareholders over time.

We believe that patient value investing is the most sensible approach to compounding wealth over time. We view the price you pay for an asset to be as important as the quality of the asset. As always, we encourage investors to take a long-term time horizon when investing. There are times when an investment manager's performance is far better than the quality of the underlying decisions, because their investment style is in favour, or some good fortune positively affects a number of key positions, or they do not suffer from as many unforeseen negative circumstances as an investment manager would normally expect over the course of a year. The opposite can also be true. We will remain consistent in our approach and maintain our focus on generating strong risk adjusted returns for our investors.

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