# Auscap Long Short Australian Equities Fund

# Newsletter – January 2019

## Fund Performance*

| Period | Auscap | All Ords |
|---|---|---|
| December 2018 | (4.5%) | (0.5%) |
| Financial Year To Date | (15.8%) | (7.3%) |
| Since Inception | 151.4% | 63.1% |
| Annualised Returns | 16.4% | 8.4% |

## Fund Exposures

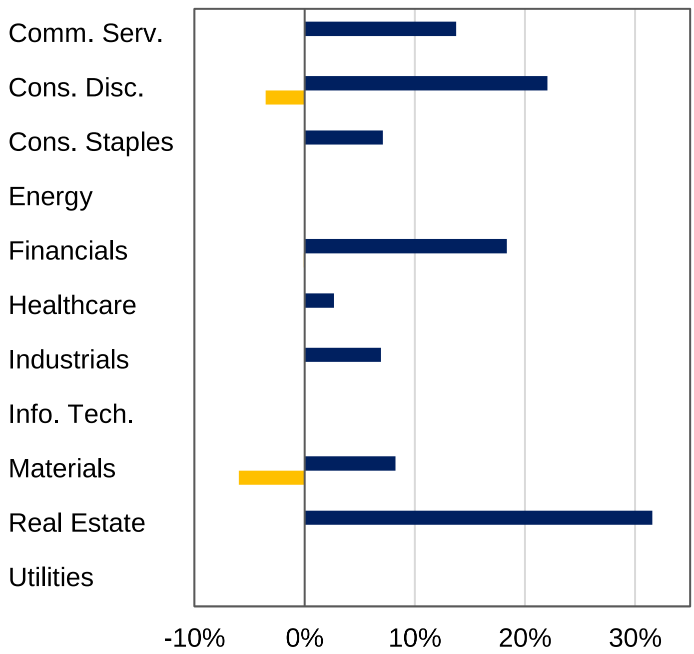
| December 2018 Average | % NAV | Positions |
|---|---|---|
| Gross Long | 110.6% | 34 |
| Gross Short | 9.6% | 7 |
| Gross Total | 120.2% | 41 |
| Net / Beta Adjusted Net | 101.0% | 73.7% |

## Portfolio Commentary

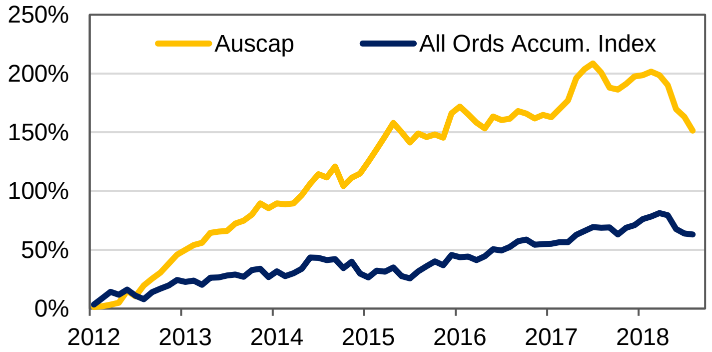
The Fund returned negative 4.5% net of fees during December 2018. This compares with the All Ordinaries Accumulation Index return of negative 0.5%. Average gross capital employed by the Fund was 110.6% long and 9.6% short. Average net exposure over the month was 101.0%. Over the month the Fund had on average 34 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the communication services, consumer, financials and real estate sectors.

The Fund's long positions were a significant drag on performance. This was partially offset by a small contribution from the Fund's short positions. The Fund's long exposure to the real estate sector made a positive contribution over the month. The largest detractors to performance came from the Fund's long exposure to the communication services, financials, consumer discretionary and materials sectors.

## Sector Exposure - December 2018




## Fund Performance*




## Top 10 Investments^

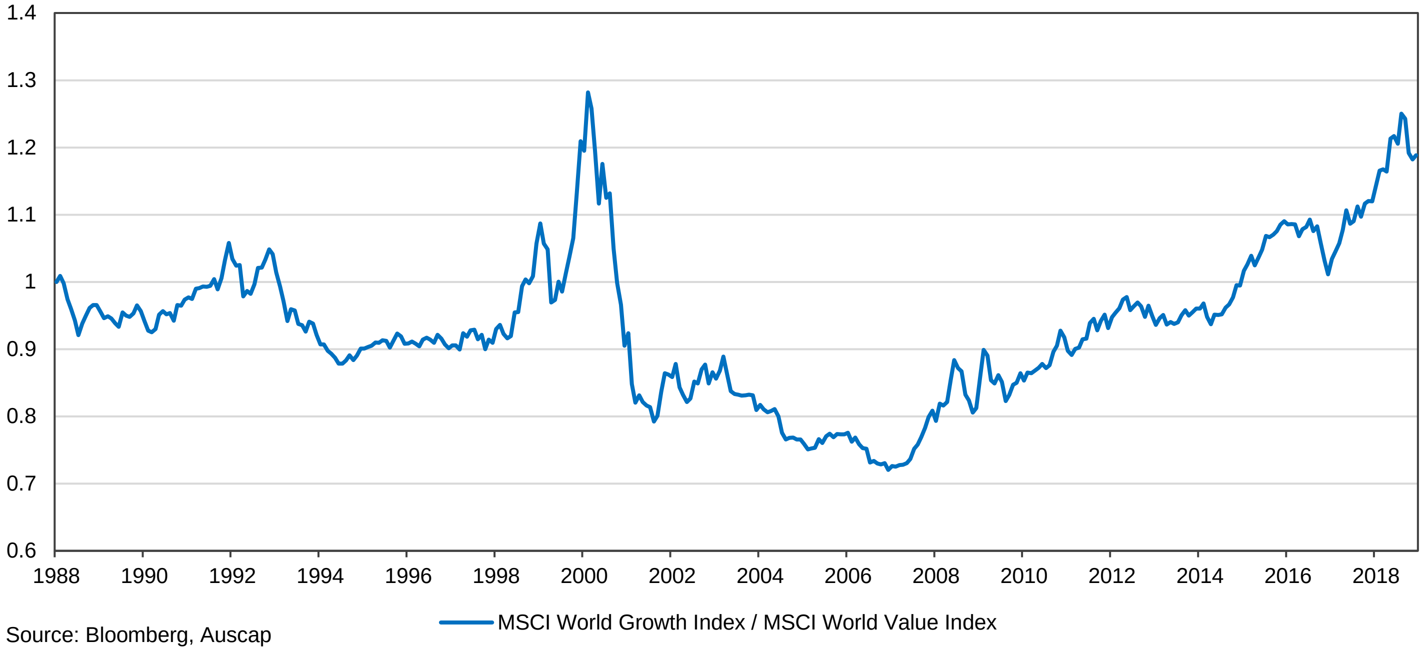
| | |
|---|---|
| Adelaide Brighton | GDI Property Group |
| Atlas Alteria | JB Hi-Fi |
| Blackmores | Macquarie Group |
| Centuria Metropolitan REIT | Mineral Resources |
| CYBG | Nine Entertainment |

** 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 2018.*

## Is There Value In Value Investing?

Growth gained. Value remained out of vogue. This could neatly summarise the local and international equities markets in 2018. In fact, it might appropriately summarise equities markets over quite a number of recent years. As the charts below demonstrate, growth has outperformed value as an investment style since 2008, a trend that has accelerated over the last two years.

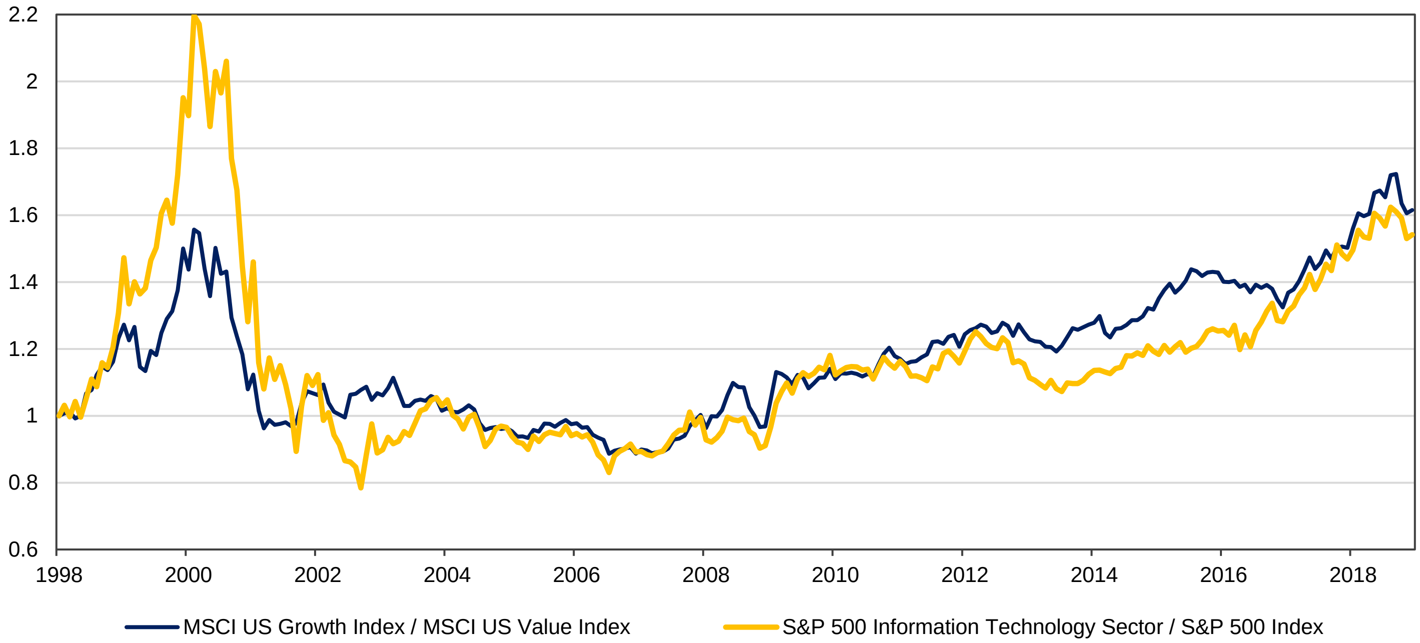
**World Growth vs Value**




Source: Bloomberg, Auscap

The outperformance has been even more pronounced in the United States stockmarket, aided by the emergence and outperformance of the technology sector over the last twenty years, a sector in which the United States has been the unquestionable leader.

**United States Growth vs Value**




Source: Bloomberg, Auscap

In the domestic market, high growth, high price to earnings (P/E) multiple companies dominated the list of 21 companies in the ASX 200 Industrials Index that generated a return of 20% or more in 2018. This group of companies included many of Australia's technology companies, such as Afterpay Touch Group, Altium, Appen, Bravura Solutions, Technology One, WiseTech Global and Xero. Some of these higher multiple companies are very good businesses that will grow into their current valuation. Strong forecast earnings growth warrants a higher multiple of earnings. However, the higher the earnings multiple the stronger and longer the earnings growth that is required to justify investment.

Generally speaking, if a company's share price return exceeds its earnings per share growth, part of the return has come from an expansion of the P/E multiple. This certainly occurred in many high growth companies in 2018. The average forecast P/E multiple for the group of stocks in the ASX 200 Industrials Index that generated a return of more than 20% last year is 52x[1]. Historically we have found that multi-year assumptions of continual strong growth are often optimistically biased, leaving more investment downside than upside from purchases made at elevated prices. Paying too much for a high growth company can lead to poor investment outcomes. Many of the high growth companies in the domestic market appear to be priced on the assumption that strong growth will continue uninterrupted for some time. Purchasing at such prices, in our view, leaves the range of investor outcomes skewed to the downside.

By contrast, there is a heavy concentration of lower P/E stocks amongst the 36 companies in the ASX 200 Industrials Index whose total return in 2018 was worse than minus 20%. Many of these companies had stock specific issues over the year, resulting in a near term decline in earnings, helping to explain their negative return. In these cases, the share price decline was largely a reflection of the change in the company's circumstances. However, in a few select instances the compression of the company's P/E multiple appears to have been disproportionate to the change (if any) in its forecast earnings and the underlying value of the business. Such share price declines can represent attractive investment opportunities, with a significant amount of negativity priced in and very little attention given to what might go right over the medium term and what value might be realised.

We believe that buying companies for less than they are worth is the best approach to long term value creation. This typically occurs when the market is negatively predisposed, focused on short term issues that are likely to prove temporary in nature, and making pessimistic assumptions about future cash flows. In our opinion the outperformance of growth over value as an investment style is cyclical rather than structural. We would also distinguish our value-based approach from simply purchasing low P/E multiple stocks or a contrarian approach of buying stocks that are out of favour whose share prices have declined substantially. We like to purchase companies trading at valuations that, in our view, seem low compared to the quality of the business and the company's opportunity for earnings and revenue growth. There is no one P/E multiple that justifies investment. An attractive price is a function of many criteria.

The Fund had a disappointing year in 2018. It was the sixth full calendar year for the Fund, and the first in which the Fund has suffered a decline. Given our value management style, the strong trend in growth outperforming value played a part. However, we take full responsibility for performance and look to learn from experience. As we have always reiterated, when performance is poor we will increase disclosure and transparency, treating our investors in the way we would like to be treated if our roles were reversed.

In early January we released an investor letter to our direct investors with their unitholder statements which provided a performance summary, gave a brief description of our top ten investments as at 31 December 2018 (listed on the first page of this newsletter) and discussed key takeaways and lessons from the year. If you are an *indirect* investor through a platform or adviser group and would like to receive a copy of the investor letter please email us at investors@auscapam.com or request a copy from your advisor.

We thank you for your continued support and readership and wish you and your loved ones a wonderful 2019.

[1] Based on Bloomberg consensus forecast P/E estimates as at close of business on 18 January 2019.

*Australia*
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