Auscap Long Short Australian Equities Fund

Newsletter – July 2019

Fund Performance*

Period	Auscap	All Ords
June 2019	(3.2%)	3.4%
Financial Year To Date	(9.2%)	11.0%
Since Inception	171.2%	95.4%
Annualised Returns	16.36%	10.7%

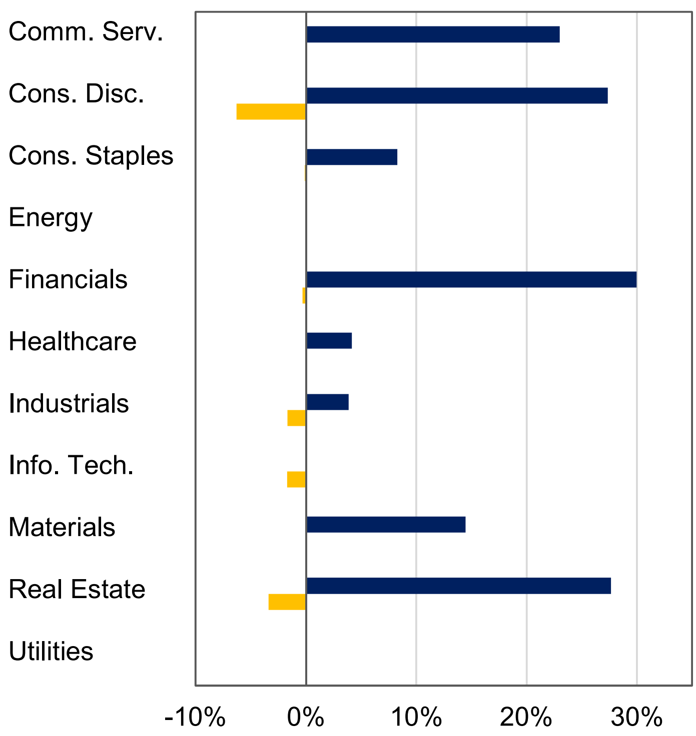
Fund Exposures

June 2019 Average	% NAV	Positions
Gross Long	138.7%	38
Gross Short	13.5%	10
Gross Total	152.2%	48
Net / Beta Adjusted Net	125.2%	107.9%

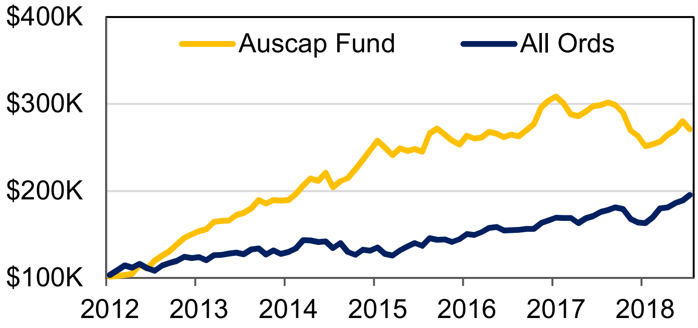
Portfolio Commentary

The Fund returned negative 3.2% net of fees during June 2019. This compares with the All Ordinaries Accumulation Index return of 3.4%. Average gross capital employed by the Fund was 138.7% long and 13.5% short. Average net exposure over the month was 125.2%. Over the month the Fund had on average 38 long positions and 10 short positions. The Fund's biggest stock exposures at month end were spread across the financials, real estate, consumer, communication services and materials sectors.

Sector Exposure - June 2019



Fund Performance*



Fund Financial Year Returns*

FY	%	FY	%
FY13	19.7%	FY17	8.0%
FY14	46.0%	FY18	12.7%
FY15	16.8%	FY19	(9.2%)
FY16	20.1%	CY19	7.6%

Top 10 Investments^

Adelaide Brighton	JB Hi-Fi
Blackmores	Macquarie Group
Centuria Metropolitan REIT	Mineral Resources
CYBG	Nine Entertainment
GDI Property Group	Super Retail 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 30 June 2019.

Is Negative Sentiment Creating Opportunities?

Recently there has been considerable focus in the press and across the investment community on the state of the Australian economy. Most of this attention has been focused on the negatives. This list frequently includes a discussion of falling house prices, the contraction in the availability of credit for home buyers and residential investors, the likelihood of a coming decline in residential construction given falling residential building approvals, domestic consumption growth that is lower than it has been historically and the decision by the Reserve Bank of Australia (RBA) to cut interest rates. This commentary has continued despite the fact that house prices appear to be stabilising and credit availability is likely to improve following recent changes to the Australian Prudential Regulatory Authority's guidelines in relation to lending practices.

Very little is being said about what is currently going right for the domestic economy. From our perspective, the positives outweigh the negatives and present a compelling picture for investment. The unemployment rate is low and job vacancies continue to be high, with sufficient job creation to cater for strong population growth. The wealth of the average household is now above one million dollars for the first time. The Australian Federal Government is likely to produce a fiscal surplus in financial year 2020, the first since 2007, allowing for increases in fiscal stimulus through reductions in taxation and increases in expenditure, both of which should increase consumption. Public investment, particularly in infrastructure, continues to boom. The recent election outcomes at the Federal and State levels should provide businesses with certainty on a go forward basis and the re-election of these governments has provided policy continuity. Australia's terms of trade are very healthy due to strength in commodity prices and volumes, which should continue for some time due to a lack of new global supply in Australia's key commodities. Based on recent decisions by Australia's major mining and energy companies, private investment is set to increase towards the end of 2019 as they commence significant capital expenditure for replacement and expansion projects. And finally, interest rates are the lowest they have ever been, and hence monetary policy is accommodative which is supportive of economic growth. This looks unlikely to change any time soon.

The pervasive bearish sentiment of investors towards domestic-facing businesses does not appear to be supported by an objective analysis of the facts at hand. As Philip Lowe, Governor of the RBA, said recently, "*the central scenario for the Australian economy remains reasonable, with growth around trend expected*". Further, "*the outlook is being supported by our lower interest rates, by… tax cuts, by higher levels of investment in infrastructure, by a pick-up in the resources sector and the stabilisation of the housing market.*"

Understanding market, sector or stock sentiment is important because it typically indicates positioning and therefore asset pricing. When investors are bearish, they hold fewer equities or companies within these "risky" sectors and higher levels of cash, Government bonds and sectors perceived to be "safer". So broad negativity creates upside risk to equities when economic circumstances turn out to be better than expected. Conversely, bullish sentiment is typically accompanied by higher levels of risk taking through increased exposure to equities or the favoured sectors, lower cash levels and less defensive positioning. Such positioning is also associated with higher prices, where the deployment of capital into equity markets leads to listed companies trading on higher multiples of earnings. Positive sentiment creates its own downside risk should economic outcomes turn out to be worse than market expectations.

Historically we have found extreme swings in sentiment to present profitable opportunities. At these extremes, extrapolation of recent conditions is commonly assumed. What has been happening is presumed to continue. Very few investors or analysts can imagine significant deviation from their base assumptions. As a result, companies that are benefitting from existing trends or data are bought and trade at elevated levels, whereas companies facing near term headwinds are sold down to bargain prices. Our objective is to reduce our holdings in companies where tailwinds are well known and priced to continue, and buy those businesses that are attractively priced where the market assumption is that headwinds affecting the sector are expected to continue forever, contrasting to our view that these headwinds will prove transitory. Of course, a value investor always has to be mindful of the risk that the headwinds are not seasonal or cyclical, but structural. We aim to avoid investments in businesses where we believe the headwinds are structural.

Long term we remain extremely bullish on the prospects for the Australian economy and hence investment in domestically exposed businesses. The economy is supported by a significant number of factors, which include:

- Strong population growth driven both by a reasonable rate of natural increase and positive net migration;
- Large natural in-ground commodity resources with the benefits flowing to what is a relatively small population;
- Proximity to a large number of fast-growing emerging economies in Asia;
- Relatively low government debt;
- An entrepreneurial culture known for its innovation;

- A stable democracy with shared access to education, health and welfare;
- Separation of powers, a strong rule of law and judicial independence;
- Private property ownership; and
- Strong regulatory institutions, including an independent central bank.

This list is far from exhaustive. We believe the factors that have always allowed Australia to prosper and outperform many peers will continue to support growth in the domestic economy and provide good long term investment opportunities. These opportunities are typically greatest at the points in time when the majority are bearish. We continue to look to invest in high quality businesses when they trade at attractive prices.

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