Auscap Long Short Australian Equities Fund

Newsletter – March 2019

Fund Performance*

Period	Auscap	All Ords
February 2019	1.2%	6.1%
Financial Year To Date	(14.0%)	2.2%
Since Inception	156.8%	79.9%
Annualised Returns	16.3%	9.9%

Fund Exposures

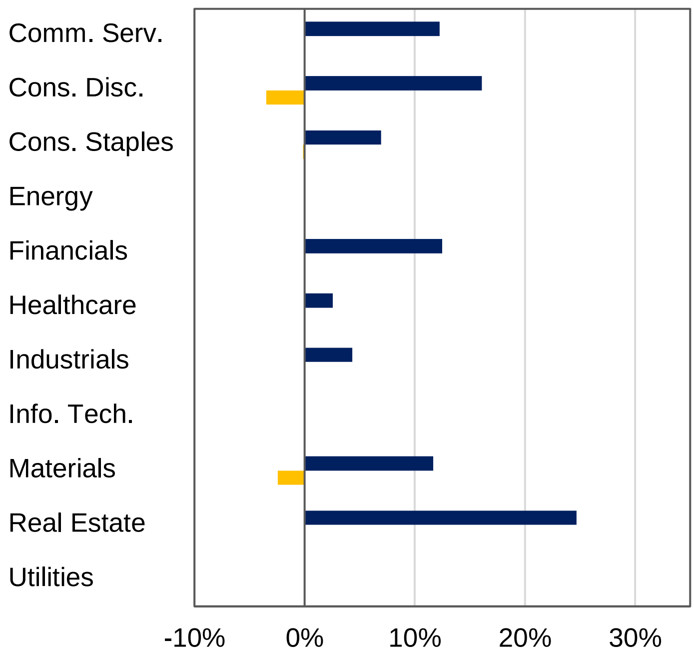
February 2019 Average	% NAV	Positions
Gross Long	91.0%	31
Gross Short	6.1%	4
Gross Total	97.1%	35
Net / Beta Adjusted Net	84.9%	71.9%

Portfolio Commentary

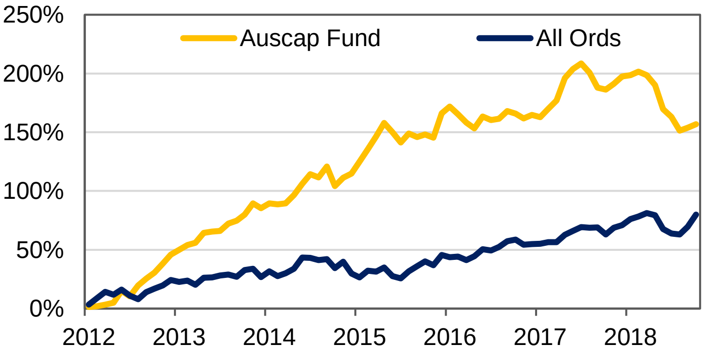
The Fund returned 1.2% net of fees during February 2019. This compares with the All Ordinaries Accumulation Index return of 6.1%. Average gross capital employed by the Fund was 91.0% long and 6.1% short. Average net exposure over the month was 84.9%. Over the month the Fund had on average 31 long positions and 4 short positions. The Fund's biggest stock exposures at month end were spread across the communication services, consumer, financials, materials and real estate sectors.

The Fund's long positions delivered a positive contribution to returns. This was partially offset by its short positions which were a small drag on performance over the month. The largest positive contributors were from the Fund's holdings in communication services, consumer discretionary and financials companies. Short positions in companies in the materials and consumer discretionary sectors negatively impacted performance.

Sector Exposure - February 2019



Fund Performance*



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 28 February 2019.

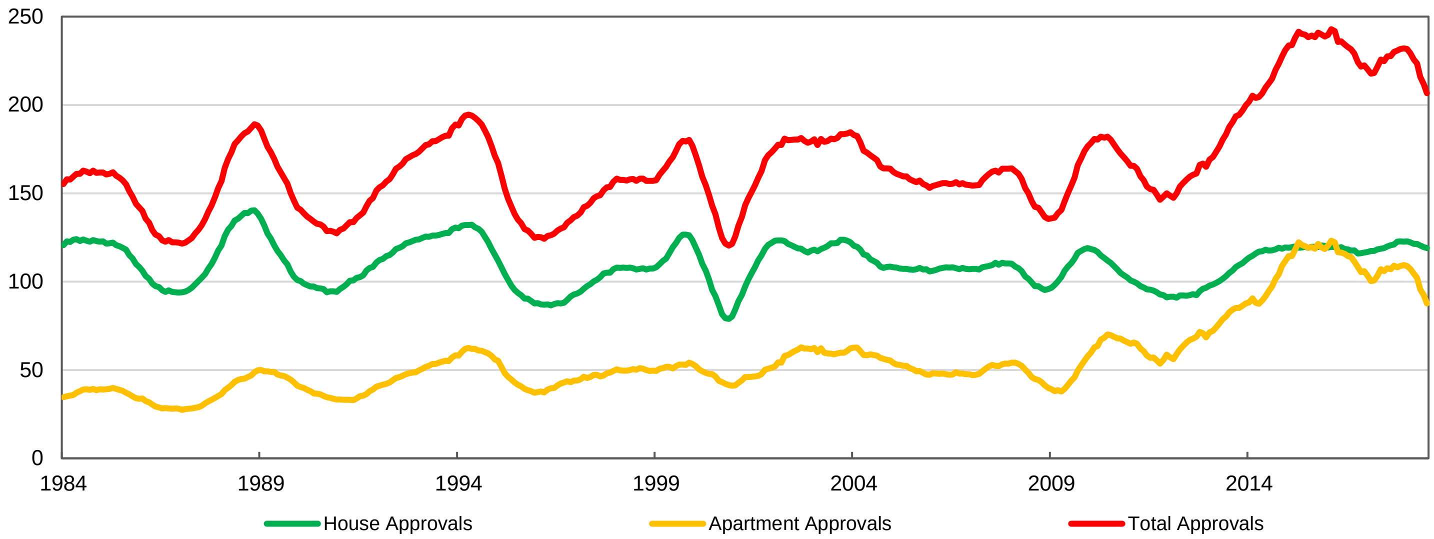
The Residential Construction Contraction Conundrum

Can Australia handle a contraction in residential construction? This is the question perplexing many market commentators. There is an adjustment occurring in the residential property market. Property prices nationwide peaked in late 2017 and have since fallen by 9%, bringing them back to mid-2016 levels. According to CoreLogic, property prices peaked in Sydney in July 2017 and have now been declining for 20 months with the market down 13.2%. The recent decline in property values has been steeper than most previous declines. Many have focused on the impact from the Royal Commission.

Reserve Bank of Australia (RBA) Governor Philip Lowe stated in an address to the AFR Business Summit on 6 March 2019 that *"the maximum loan size offered to new borrowers has fallen by around 20 per cent since 2015. This reflects a combination of factors, including more accurate reporting of expenses, larger discounts applied to certain types of income and more comprehensive reporting of other liabilities. Even so, only around 10 per cent of people borrow the maximum they are offered."*

With property prices, housing turnover and housing credit growth falling, building approvals have also slowed.

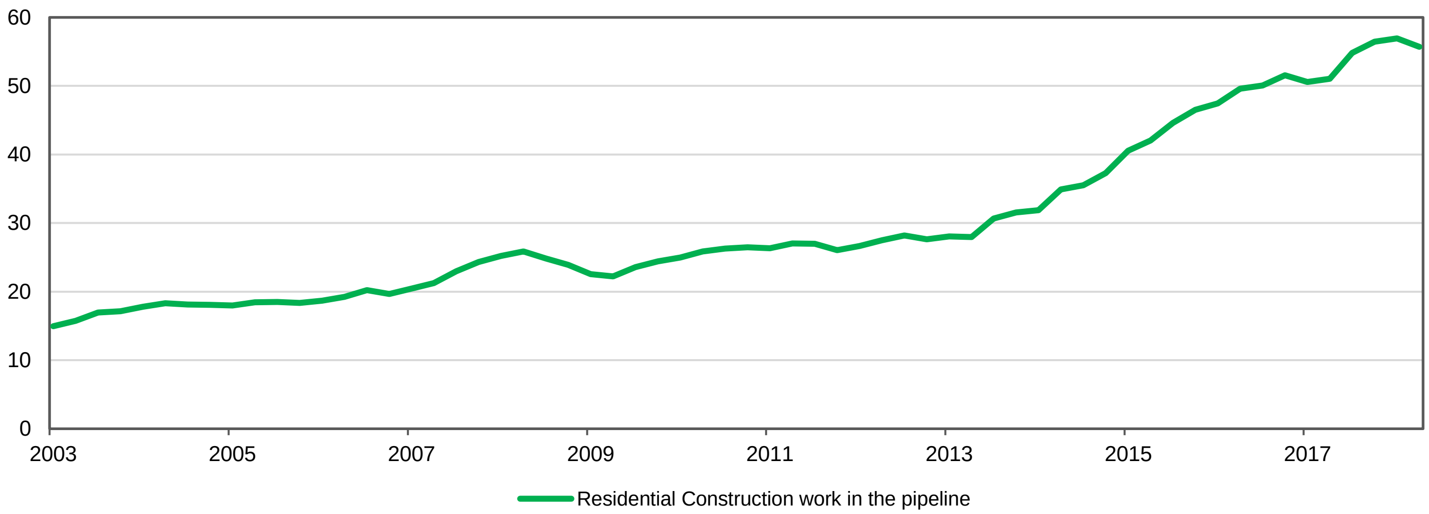
Australian Building Approvals ('000)



Source: ABS, Auscap

The fall in building approvals is leading to concern that a decline in residential construction will result in a significant contraction in investment activity. It has been suggested that the decline may not be imminent, due to the volume of work in hand in the residential construction sector.

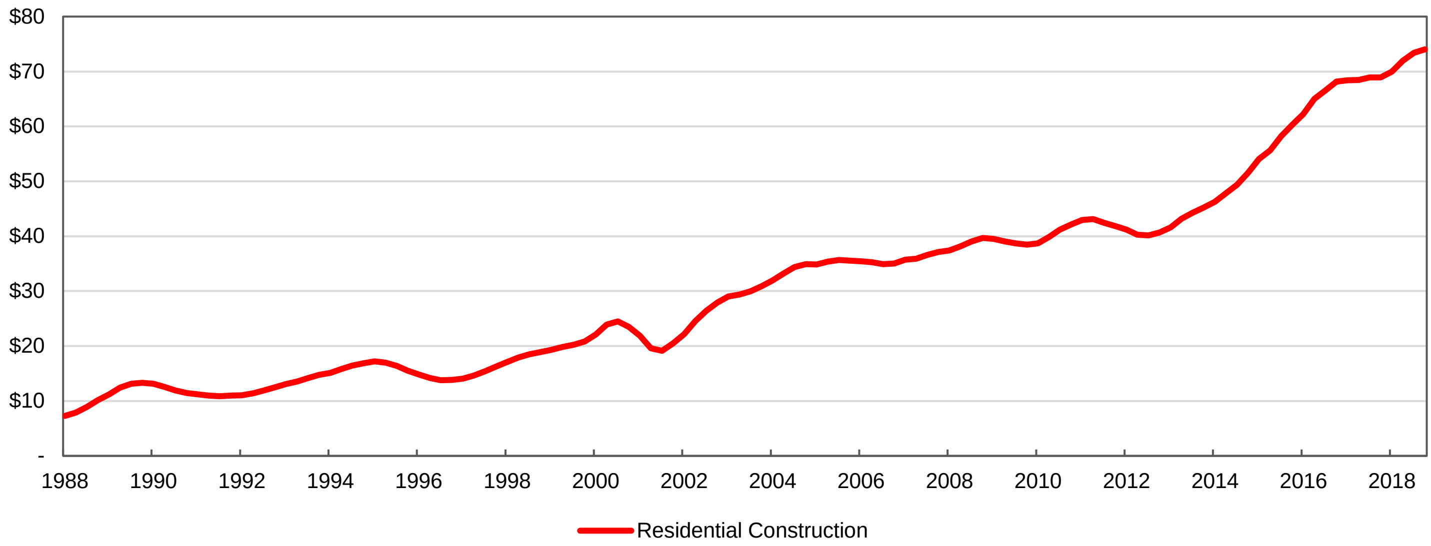
Value of Building Work In Hand ($bn)



Source: ABS, Auscap

However, fast forward 12 months and the decline in approvals is likely to result in a decline in residential construction activity. The question is, how significant will the decline be to the broader economy?

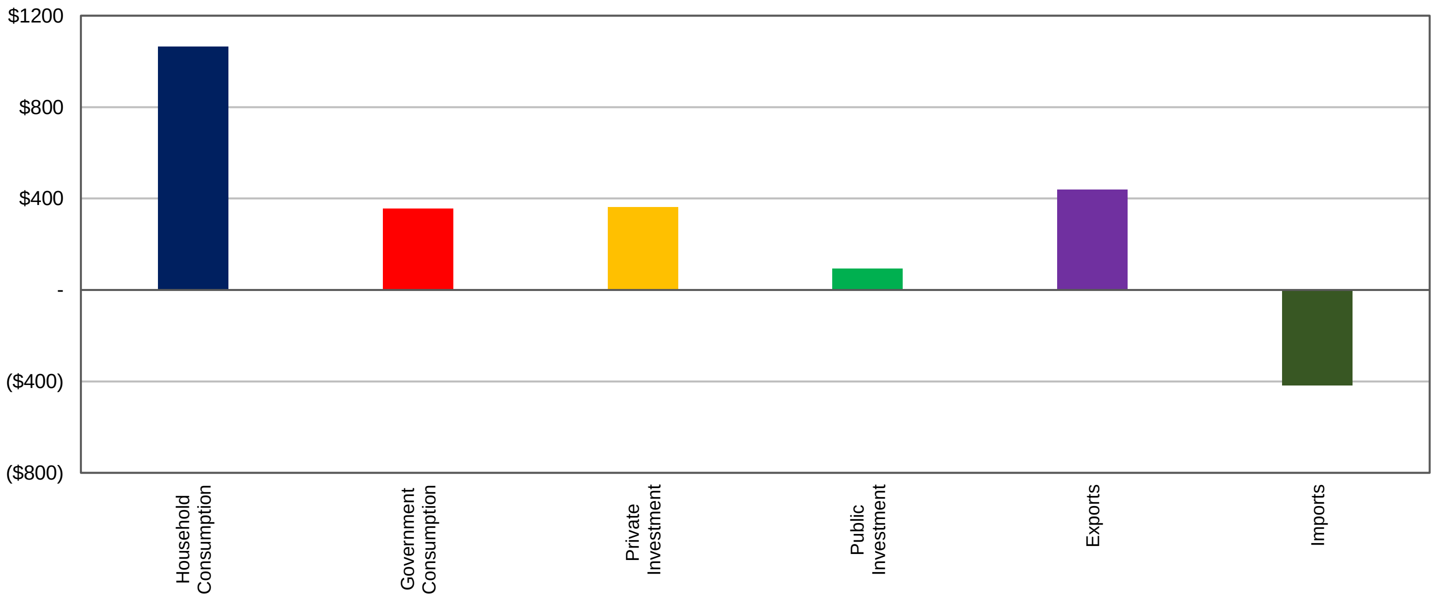
Australian GDP - Investment By Category ($bn)



Source: ABS, Auscap

Residential construction contributed $74bn to the Australian economy in 2018. Were the fall in construction activity to be 20-30%, $15bn to $20bn would be detracted from Australia's GDP. The effect could be greater if this slowdown in activity spills over into related sectors of the economy, something that is difficult to predict[i]. How significant is the potential decline in residential construction activity to the Australian economy? Private and public investment contribute circa $450bn in aggregate to Australia's total GDP of $1.9 trillion each year. So $20bn is approximately 1% of Australia's GDP.

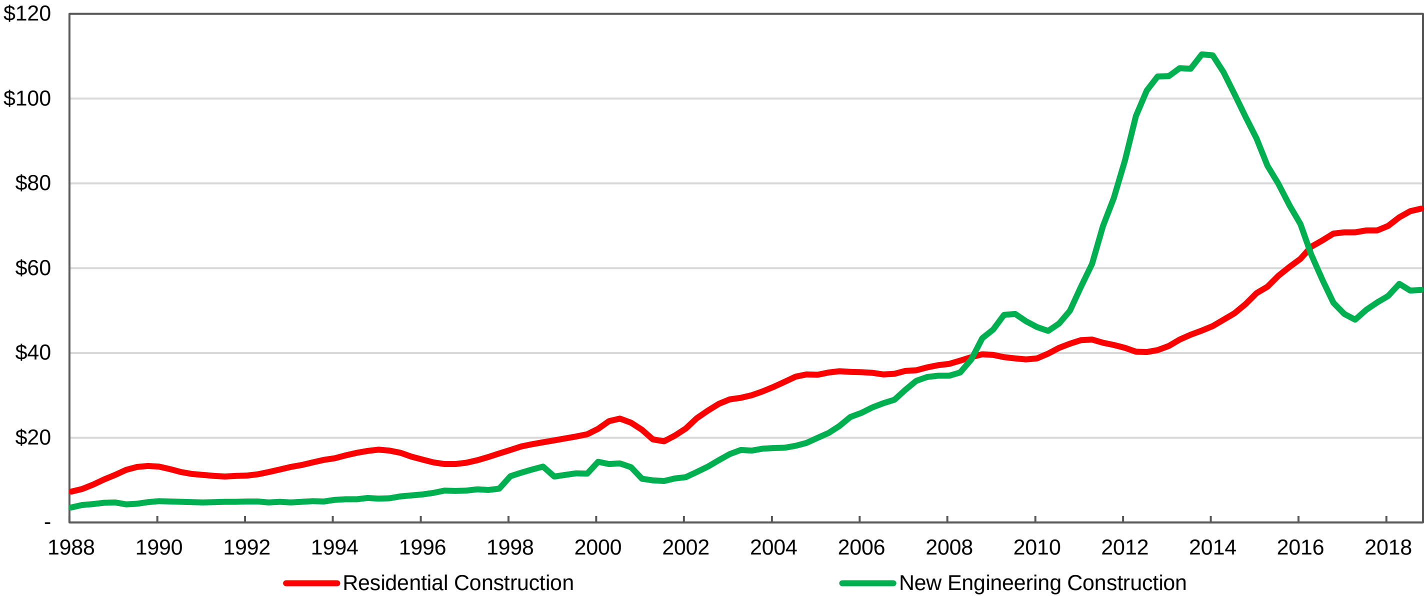
GDP Breakdown ($bn)



Source: ABS, Auscap

It is worth noting that the Australian economy has, in the recent past, dealt with a far larger contraction in investment activity. At the height of the mining, oil and gas boom, engineering activity contributed approximately $110bn to Australia's GDP. Following the completion of this work, this contribution dropped to under $50bn per annum within a few years. This contraction resulted in aggregate investment drifting backwards for a number of years earlier this decade. This suggests that as long as there are compensating factors, Australia's economy is able to handle a sector contraction.

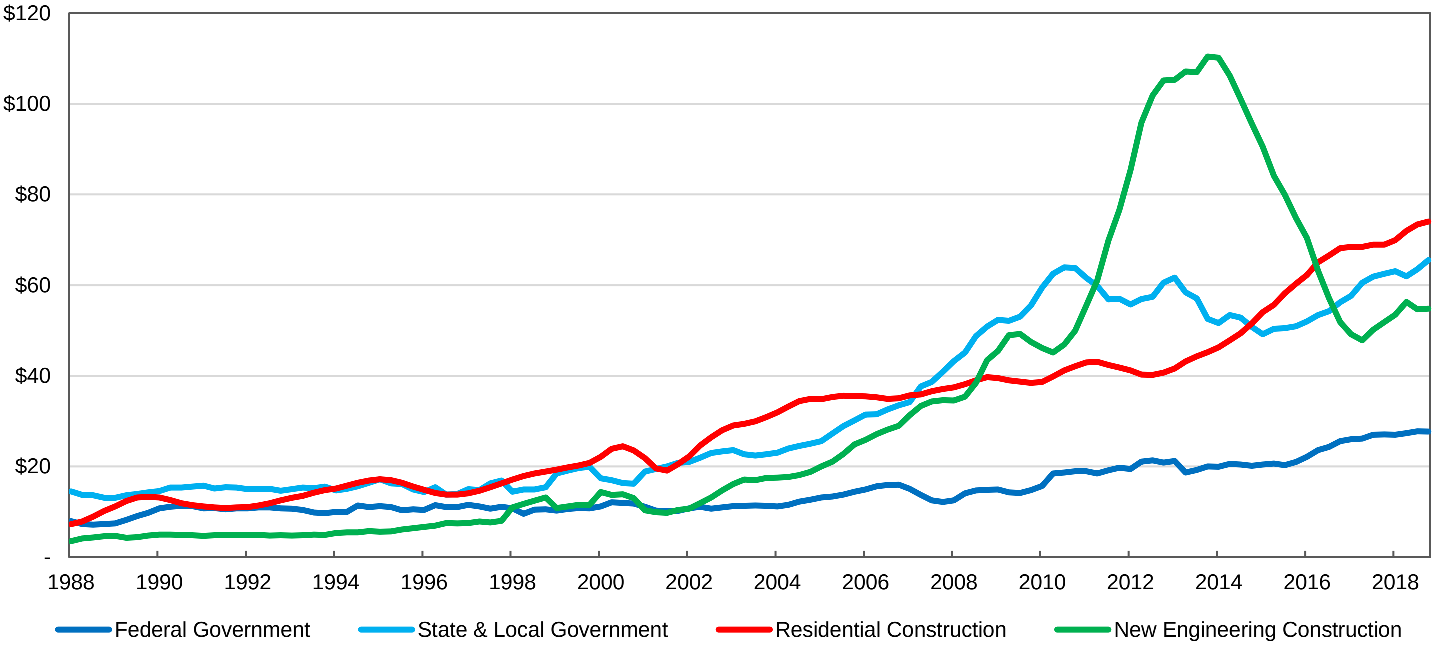
Australian GDP - Investment By Category ($bn)



Source: ABS, Auscap

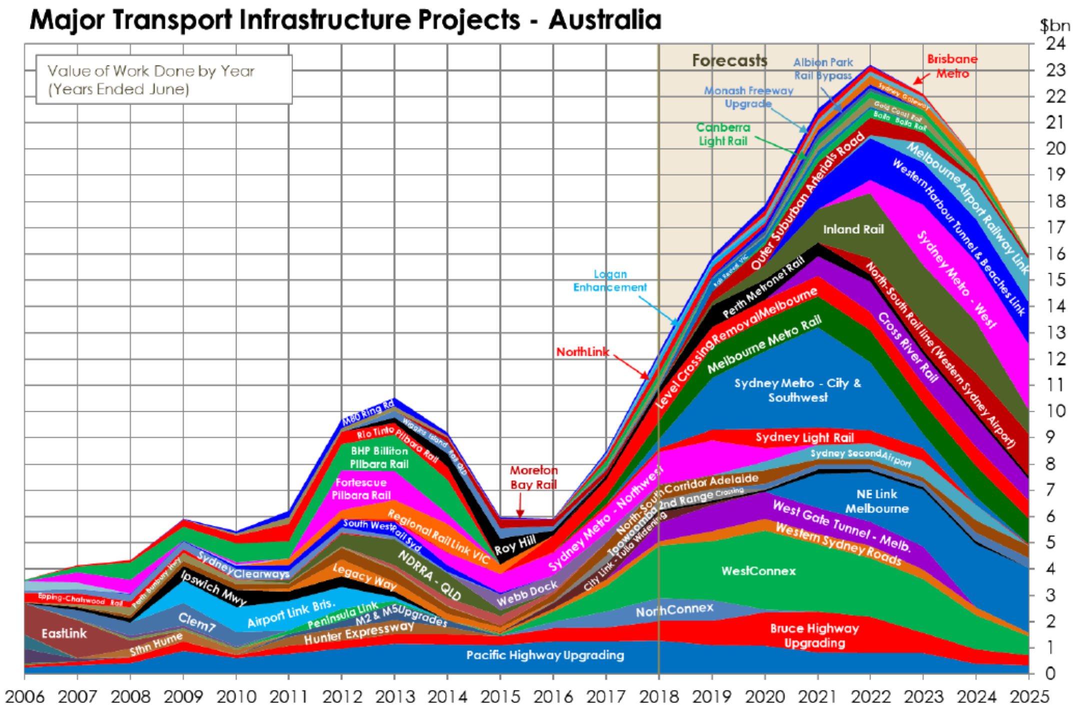
So are there compensating factors that might assist the economy with the forecast decline in residential construction activity? The answer appears to be yes. State and local governments are promising significant increases in infrastructure investment over the next three years. The Labor Government in Victoria secured victory late in 2018 with discussion of $95bn worth of investment spend on infrastructure, with over $30bn to be spent over the next few years[ii]. The incumbent Liberal Government has promised the commencement of $70bn of expenditure on transport infrastructure should it win another term in office at the upcoming New South Wales state election, while Labor has promised $50bn worth if it is successful[iii]. And with a Federal election looming, promises in relation to Government investment may continue to grow.

Australian GDP - Investment By Category ($bn)



Source: ABS, Auscap

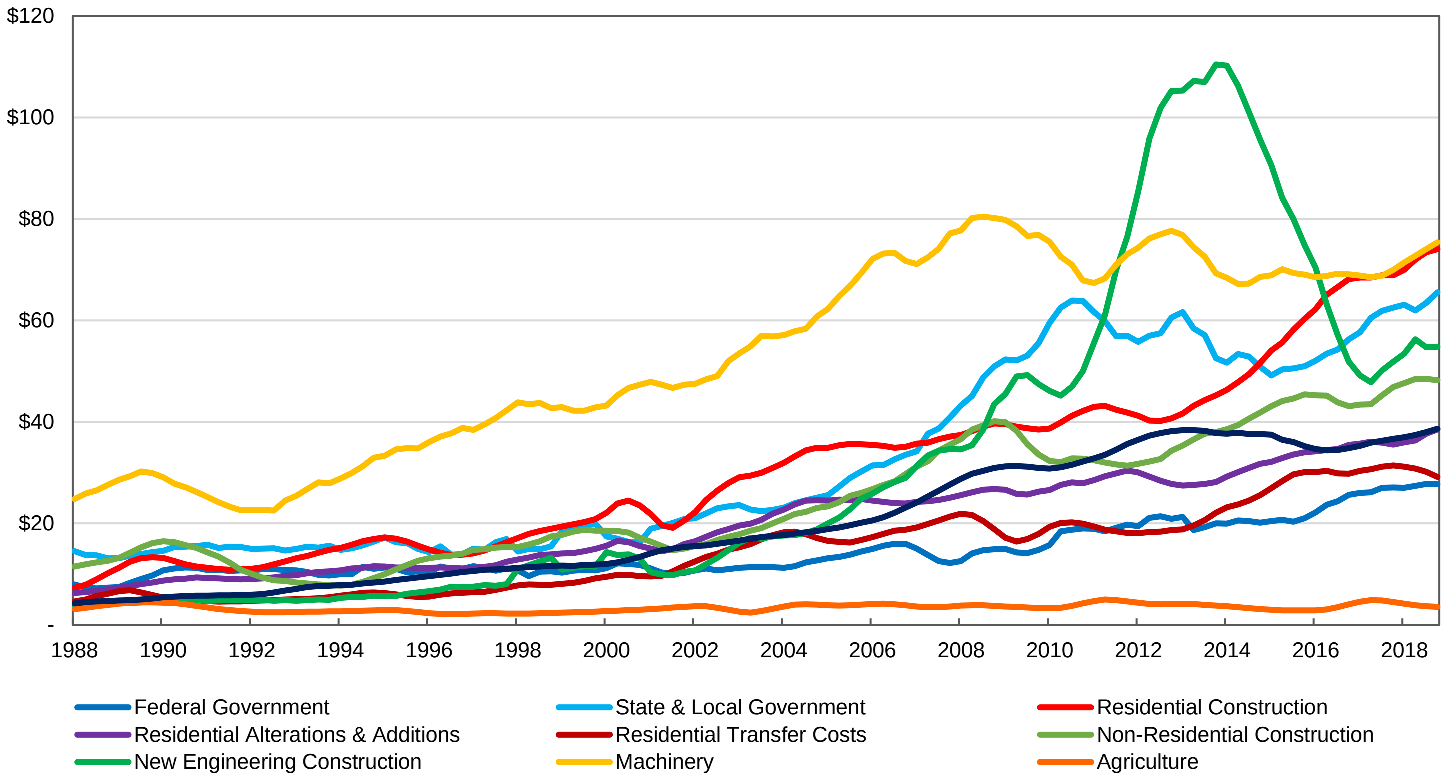
Incremental infrastructure promises will add to the boom that we are already experiencing. The forecast major transport infrastructure projects as at December 2018 are highlighted in the chart below.



Source: macromonitor, Cimic

Additionally, there are other sources of likely growth. Engineering investment may have bottomed. In 2018 there were significant approvals for iron ore projects in the Pilbara. BHP approved the AU$4.8bn South Flank project to replace its Yandi mine, Rio Tinto approved an AU$3.5bn investment in the Koodaideri iron ore mine, while Fortescue approved spending AU$1.8bn on the new Eliwana mine and rail project in the West Pilbara. Many other categories of investment are also on an upward trajectory.

Australian GDP - Investment By Category ($bn)



Source: ABS, Auscap

And in time residential construction, should it fall as expected, will recover. The RBA does not believe that there has been a significant overbuild of residential housing. Australia's population is growing quickly, with the Australian Bureau of Statistics forecasting the formation of over 170,000 new households a year. This provides a constant source of demand for new housing. Australia's population growth is solid and supports the likelihood of strong economic growth. We recognise that the housing slowdown might present some risks to the domestic economy, however these risks presently appear manageable. While we continue to closely monitor the data, it currently provides support for a thesis that Australia may, absent external shocks and barring unforeseen circumstances, be able to navigate the current slowdown in residential construction. It seems appropriate for Governor Lowe to have the final word.

"*The adjustment in our housing market is manageable for the overall economy. It is unlikely to derail our economic expansion. It will also have some positive side-effects by making housing more affordable for many people.*"

RBA Governor Philip Lowe, 6 March 2019

[i] The RBA recently focused on the impact of falling house prices on household consumption. While this is not the focus of this newsletter, we note their estimate that a 10% increase in net housing wealth would raise consumption by around 0.75% in the short run and 1.5% in the longer run (Source: Governor Philip Lowe, Reserve Bank of Australia, *"The Housing Market and the Economy"*, Address to the AFR Business Summit, 6 March 2019)

[ii] https://www.abc.net.au/news/2018-11-21/victorian-election-is-all-about-transport/10514110

[iii] http://theconversation.com/how-the-nsw-election-promises-on-transport-add-up-112531

Auscap Long Short Australian Equities Fund

Newsletter – March 2019

Australia

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