Auscap Long Short Australian Equities Fund

Newsletter – May 2019

Fund Performance*

Period	Auscap	All Ords
April 2019	2.0%	2.5%
Financial Year To Date	(9.6%)	5.7%
Since Inception	169.9%	86.0%
Annualised Returns	16.7%	10.1%

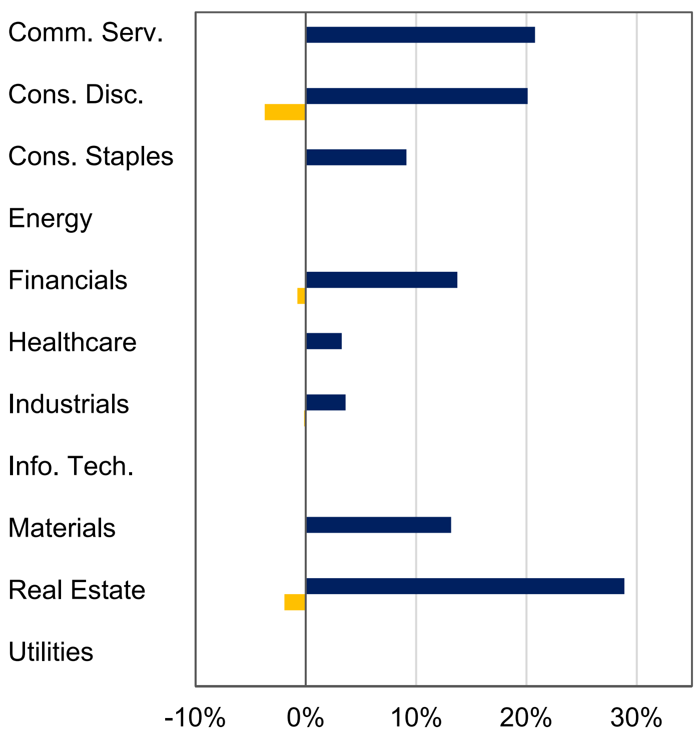
Fund Exposures

April 2019 Average	% NAV	Positions
Gross Long	112.7%	35
Gross Short	6.6%	7
Gross Total	119.3%	42
Net / Beta Adjusted Net	106.1%	90.6%

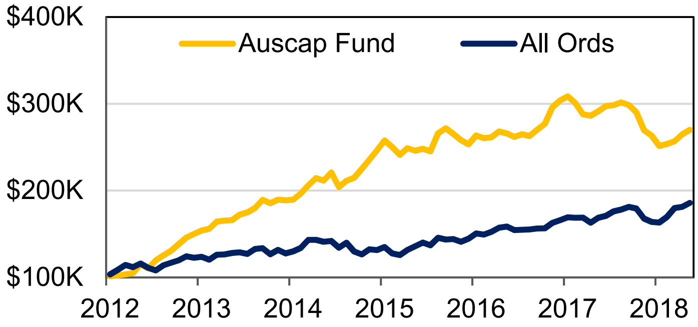
Portfolio Commentary

The Fund returned 2.0% net of fees during April 2019. This compares with the All Ordinaries Accumulation Index return of 2.5%. Average gross capital employed by the Fund was 112.7% long and 6.6% short. Average net exposure over the month was 106.1%. Over the month the Fund had on average 35 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, communication services, consumer, financials and materials sectors.

Sector Exposure - April 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	(9.6%)
FY16	20.1%	CY19	7.3%

Top 10 Investments^

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

Mistaking Value Investing For Buying Low PE Stocks

"All investing is value investing… the same calculation goes into it whether you're buying some bank at 70% of book value or you're buying Amazon at some very high multiple of reported earnings."

Warren Buffett, Berkshire Hathaway ASM 2019

We are frequently asked about why we own a few stocks that have a high price to earnings (PE) ratio. The implicit assumption within the question is that a high PE stock cannot be a value stock. To many, it would appear that buying companies with high PE ratios runs contrary to a value-based investment philosophy. Yet nothing could be further from the truth. In this newsletter we explain our approach to value, our relative confidence in ensuring that we are buying at a reasonable discount to fair value when we invest and why the Auscap Fund portfolio typically ends up with a lower average PE than the broader market as an outcome of, rather than an input into, the investment process.

What is value investing?

Value investing is defined as buying financial assets for less than they are worth. It could be stocks, corporate debt or residential property to name a few. We all understand the value principle on a small scale, it is no different to picking up a bargain at the local market or in the Boxing Day sales. It involves determining the value of an asset and purchasing that asset at a price that is lower than its value. Sharemarket investors approach this by trying to work out the present value of all of the future cash flows of a business, and what that represents in terms of value on a per share basis. This is not an easy exercise, requires a considerable number of inputs and is dependent on some key assumptions that can turn out very differently to how an investor expected. If the key assumptions in a financial model are wrong, the resulting change in valuation can be enormous. For example, there have been a number of instances of toll roads being significantly overvalued due to optimistic forecast traffic assumptions.

As the future is unknowable, all assumptions are prone to significant inaccuracy, irrespective of the intelligence or knowledge of the forecaster, although a higher level of knowledge and experience will typically lead to less inaccuracy. Because of this, the value investor insists on purchasing shares only when they trade at a reasonable discount to what they believe is the true worth of the investment. That way, if the reality turns out to be less positive than the assumptions the investor has used to value the asset, there is a margin of safety that can be utilised before the value investor loses money on the investment. While it does not prevent a value investor from losing money, it reduces the probability of doing so.

The relationship between value and PE ratios

The value of a company is the present value of the future cash flows. If those future cash flows are growing very quickly, then the value of the company as a multiple of its current year earnings will be high. So as a value investor we might find a business that we have a high degree of certainty will grow at a rapid rate for a considerable period of time very attractive despite it trading on an above-market-average multiple of earnings. The PE premium, relative to the market, is justified by the company's superior growth prospects and can still represent a discount to the "fair value" multiple for the business given its characteristics.

Similarly, a company with modest earnings growth might also be attractive to us, but only at a discount to an appropriately lower fair value multiple of current year earnings. When assessing business value, the current PE ratio is only one small part of the equation. The growth of the business, the quality of the company's assets, the degree of certainty we have in relation to the earnings trajectory and the risk of significant variance in financial outcomes are a few of the other critical variables that require an assessment. Quantifying and evaluating the relative significance of each factor is why investing is often considered a combination of art and science.

Why do value investors tend to have more investments in low PE companies?

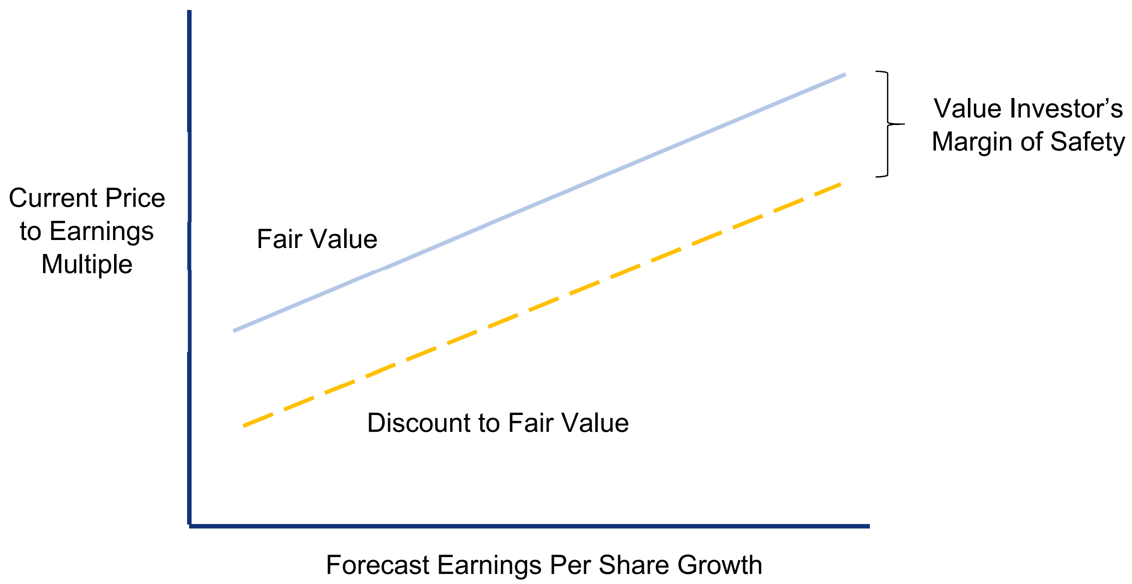
If value investors are looking to only buy into companies when they are trading at a discount to their intrinsic value, it makes sense that *on average* they will have a portfolio with a lower overall PE ratio than the broader market, even if their portfolio is representative of the broader market in terms of the average growth rate and earnings quality.

Value investors also tend to value certainty of future cash flows and the likely growth in cash flows derived from a business over time. Valuation is typically dependent on forecasting many years into the future. To be sure that you are getting a discount, you need to have conviction in your assumptions. It is easier in many ways to assume that a good business will continue to grow at a reasonable rate into the future than to have confidence in the assumption of continued high growth for many years. All experienced investment managers have seen the impact of tail-risk events on valuation. High growth industries can be disrupted, the high growth can attract new entrants who take market share, or growth can slow for any number of reasons that are not anticipated today. As the adage goes, trees don't grow to the sky.

So often it is easier to conclude that assumptions of reasonable growth into perpetuity might be more reliable than those of continued rapid growth for many years into the future. As a result, many value managers tend to have a slight bias away from very high growth businesses, because they value the safety of assumptions that are, or at least appear, more conservative and less subject to material unforeseen interruption or deviation. But it does not exclude value managers from buying high growth businesses if they are confident that they are buying at a price that represents a significant discount to the company's conservatively estimated underlying value.

We attempt to represent this diagrammatically below. The graph assumes all other factors, such as business quality, return on invested capital, balance sheet strength, and many other quantitative and qualitative attributes, are held constant.

Fair Value Earnings and Growth Relationship



Lower PE portfolios as an outcome, rather than an input

Given these natural biases, value managers tend to have lower PE portfolios than the broader market. The Auscap Fund portfolio typically has a lower PE than the broader market. But to suggest that we target such a portfolio is incorrect. In fact we constantly look for attractively priced opportunities to buy into high growth, high return on capital businesses that have a large number of future reinvestment opportunities. These businesses are certainly ones we want to own for the long term. We will continue to be selective on the prices that we pay for our investments, recognising that the current PE of a company is only one part of the valuation equation.

Just a reminder that Auscap is hosting our Annual Investor Roadshow in the coming weeks. We would be delighted if you could join us. To register your interest, please visit our website www.auscapam.com/upcoming-events

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website www.auscapam.com and follow the registration link on the home page. Interested investors can download a copy of the PDS at www.auscapam.com/auscap-fund/pds. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

Auscap Asset Management Limited

ACN 158 929 143 AFSL 428014
Lvl 30, 9 Castlereagh St, Sydney

Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
Administration: Link Fund Solutions

Tax & Audit: Ernst & Young
Legal: Norton Rose Fulbright