



Auscap Long Short Australian Equities Fund Newsletter – June 2014

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Welcome

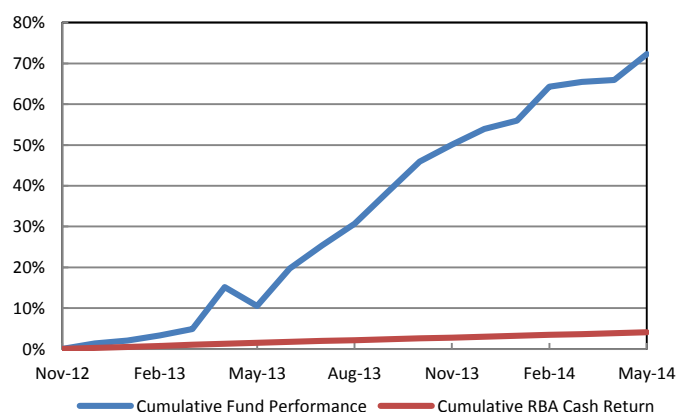
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (“Fund”) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we discuss why we prefer to invest in value stocks over growth stocks, where we focus on current earnings and the likelihood that these earnings can grow at modest and sustainable rates into the future.

Overview

The Fund was launched in December 2012 and targets strong absolute returns in excess of the RBA Cash Rate. The Fund focuses predominantly on fundamental long and short investments while utilising a multi-strategy approach to take advantage of shorter term market opportunities to increase returns, hedge the portfolio, protect capital and minimise volatility where prudent. The Fund will typically have 25-45 positions primarily in liquid stocks in the ASX200. Further information, including access for sophisticated investors to the Fund’s Information Memorandum, is available at our website www.auscapam.com. Enquiries can be directed to info@auscapam.com.

Fund Performance

The Fund returned 3.82% net of fees during May 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 117.4% long and 43.5% short. Average net exposure over the month was +74.0%. At the end of the month the Fund had 35 long positions and 10 short positions. The Fund’s biggest stock exposures at month end were spread across the consumer discretionary, telecommunications, materials and financials sectors.



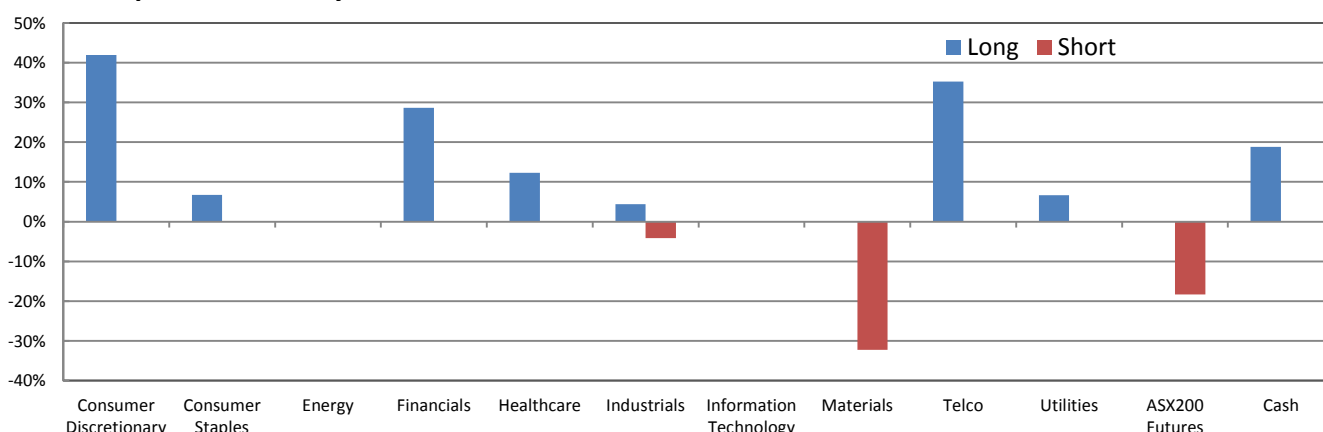
Fund Returns

Period	Auscap	Benchmark
May 2014	3.82%	0.21%
Financial Year to date	43.88%	2.34%
Since inception	72.26%	4.10%

Fund Exposure

May 2014 Average	% NAV	Positions
Gross Long	117.4%	32
Gross Short	43.5%	9
Gross Total	160.9%	41
Net / Beta Adjusted Net	74.0%	34.3%

Sector Exposure - 31 May 2014



Avoiding The Double Whammy – Why We Prefer Value To Growth

The growth versus value debate is one that has raged for some time. The debate is somewhat spurious. In most instances a stock under analysis will always have part of its valuation that can be attributed to growth and part that can be attributed to current earnings which are assumed to continue into the future. There also appears to be some conjecture around what a “value investor” is looking for. According to the ever-authoritative Wikipedia, value investing derives its ideas on investment from the Ben Graham and David Dodd teachings at Columbia Business School in the late 1920’s and 1930’s, which was later converted into the famous 1934 text, *Security Analysis*. It involves purchasing assets that appear underpriced by some form of fundamental analysis, such as those trading at a discount to net tangible book value, those with high dividend yields, and/or those with low price-earnings ratios. Warren Buffet and Charlie Munger of Berkshire Hathaway are the most famous of the value investors.

“It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.”

Charlie Munger, Vice President, Berkshire Hathaway

By contrast, growth investing involves buying companies that exhibit signs of above-average growth, even if the share price appears expensive in terms of metrics such as price-to-earnings or price-to-book ratios. In particular, growth investors are normally looking for significant market opportunities focusing on companies that have a history of strong returns when investing in new projects. Ralph Wanger, formerly of Acorn Funds Management, is one of the most famous growth fund managers.

“If you’re looking for a home run – a great investment for five years or 10 years or more – then the only way to beat this enormous fog that covers the future is to identify a long-term trend that will give a particular business some sort of edge.”

Ralph Wanger, Former Acorn Fund Manager

The definitions of value and growth investing leave considerable scope for interpretation. Our interpretation is that a value investor places considerably more weight on current earnings than they do future prospective earnings. A value investor discounts heavily any anticipation of significantly higher future earnings, and therefore struggles to purchase or consider purchasing stocks trading on high multiples.

We find ourselves in this camp. To use Wanger’s analogy, we’re not trying to hit home runs because we’re more concerned about the regular possibility of being struck out. We certainly don’t think that we are going to be able to identify any more than the rest of the intelligent fund manager universe which stocks are going to increase ten-fold or twenty-fold. Furthermore, we find it difficult to buy a company whose valuation is largely dependent on rapid and continuous growth in earnings into the immediate future. As fund managers we are aware of the constantly changing business and economic landscape. We find it near impossible to predict or pre-empt changes in technology, in politics, in the economy or in growth. We certainly don’t believe that it is possible to entirely foresee the competitive landscape either two or ten years down the track. The possible variance of outcomes on stocks where the assumption is for high growth seems to a large extent unpredictable.

As a result, our preference is to buy companies where the current underlying earnings account for a significant part of the “earnings + growth” total return on investment we are expecting when making the purchase. We like to set relatively low hurdles for the rate of growth expected of the company. If the company has a good track record of delivering consistently from a return on invested capital perspective, then we ask ourselves, is it safe to assume that their earnings will grow, over the medium term, in line with inflation and population growth? Do we expect that people will continue using the products or services for many years to come? Do we expect the company to maintain its market share? If the answer to these questions is in the affirmative, and the company is trading on a low multiple of current earnings, then we feel able to justify the purchase on a total return basis.

By contrast, we find it very difficult to have any real confidence in forecasting aggressive growth for many years into the future. And yet this is what we feel is required to justify buying a company on a high multiple of earnings. We will use an example to demonstrate what we perceive to be the risks.

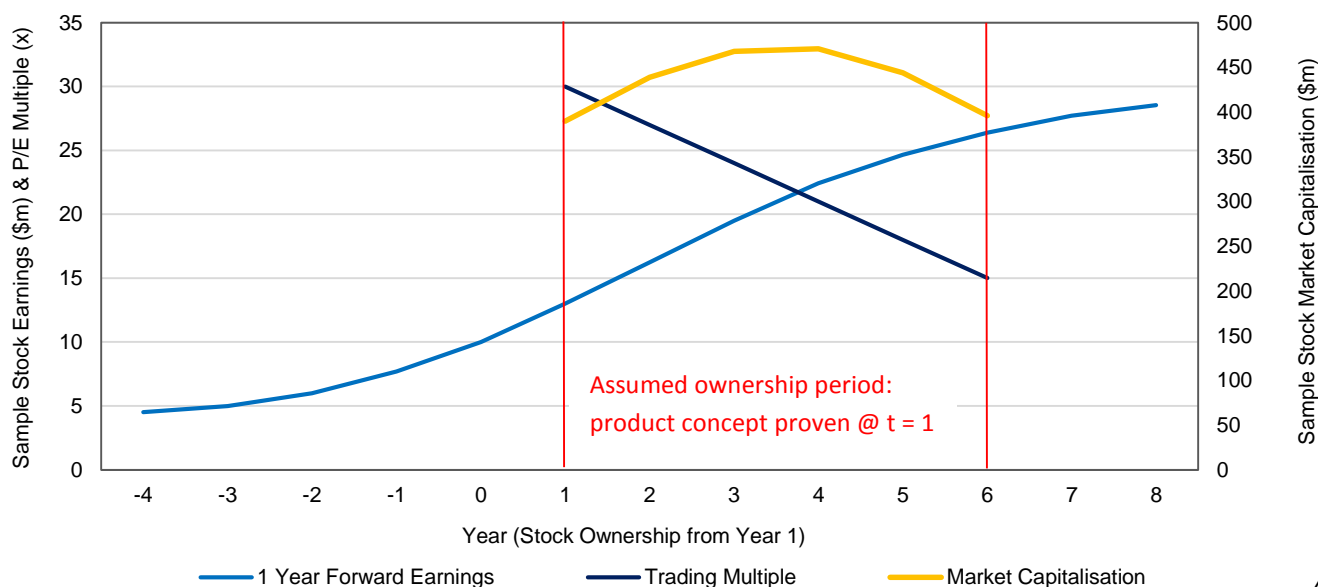
Let's assume Growthco produces some fancy widgets. They are currently the only ones producing these widgets and they make \$10m per annum in net profit. They have been operating for five years to get to this point. The concept is now proven and the widgets are popular. Because of the high growth seen in the last five years, Growthco are expected to grow earnings next year by 30% and by at least 20% the year after! Therefore the company currently trades on 30x earnings. We might add that to grow earnings by 30% is no easy feat for most companies. We assume that they do in fact grow earnings by 30% next year, then actually by 25% the year after, 20% in year 3, 15% in year 4, 10% in year 5 and 7% thereafter, following a typical S-bend in terms of growth in revenues and earnings. By year 6 they have saturated the widget market and can therefore expect to trade on a market multiple, which is closer to 15x.

Below are our expectations for the earnings of the company over time and the company's market capitalisation as its earnings grow. We have also assumed that the multiple of 1 year forward earnings that the market is willing to pay for the company declines linearly over time. Many growth investors choose to sell stocks once they are no longer growing earnings at rates that significantly exceed broader market growth rates. Here we assume a sale in year 6.

Year	1	2	3	4	5	6	7
Forecast Earnings	\$10m	\$13m	\$16.3	\$19.5	\$22.4	\$24.7	\$26.4
Forecast Earnings Growth	30%	25%	20%	15%	10%	7%	
Trading Multiple Of 1 Year Forward Forecast Earnings	30x	27x	24x	21x	18x	15x	
Market Capitalisation	\$390m	\$440m	\$468m	\$470m	\$445m	\$396m	

It is probably also safe to say that if the company has been growing this quickly, it has been doing so by reinvesting the income it has earned, instead of paying this income out in the form of dividends. Therefore the chances are high that no or very little in the way of dividends has been paid out over the course of the life of Growthco. The end result for investors is that, because of the high multiple of earnings paid upfront, there has been no meaningful return for investors over the life of this investment. This is despite very strong compound earnings growth of 17.6% over six years, equivalent to over 160% aggregate earnings growth over the period.

Growthco Market Capitalisation Movements During Growth Phase
[Assuming A Linearly Declining Multiple]



Clearly the specific earnings growth rates over the period will materially influence the outcome. If the company is able to grow earnings at 30% or more for many years then the results will be significantly different. But this feels to us like a very aggressive assumption, with a skewed variance in favour of lower growth rather than higher growth. In our example, where no capital gain or income accrued to the holder over the 6 year time horizon, we would still note that compound earnings growth of 17.6% is nothing to sneeze at. If the company grows earnings at a slower rate than forecast above, the de-rating of the multiple will happen much more quickly and the investor will likely suffer a sizeable capital loss. We have also assumed a linearly declining multiple, which is a simplistic assumption. In reality we will have no way of predicting when the market might decide to value the stock on a lower multiple, assuming a declining rate of growth in earnings.

From our perspective, we try to analyse the probability of suffering such a permanent loss of capital on any individual position. When a high multiple is paid for a stock, the probability of an error in forecasting is elevated, because not only can earnings be lower than expected, but if this is proven to be the case then the stock will also suffer from a de-rating of the earnings multiple on which it trades. This is the so-called double whammy occasionally seen in the market, where a stock that fails to meet expectations falls 20-30% in a short period as both the earnings and multiple are reassessed. We are reminded of value investor Seth Klarman's discussion of risk below.

"Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night."
Seth Klarman

From our perspective, value investing is about discounting the inherently unpredictable future and valuing what we can assess today. We value the current earnings stream, to the extent that we can assume it will continue for some time to come, considerably more than we value the future and uncertain earnings stream that might eventuate should significant growth occur. For the technically minded, we would use a lower discount rate on the expectation of a continuance of current earnings and a far higher discount rate when assessing future growth in earnings. We try to find companies which have a good track record of delivering solid returns on invested capital, where the products and services sold are not under threat or structural decline, where revenues and ultimately earnings are likely to grow in line with inflation (price) and population growth (volume) over the medium term, and where we are not paying a huge multiple for these earnings. To us this is the essence of value investing.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to www.auscapam.com and follow the registration link.

Interested wholesale investors are encouraged to download a copy of the Information Memorandum from the website, www.auscapam.com/information-memorandum.

We welcome any feedback or comments you have. Please direct them to info@auscapam.com.

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