Auscap Asset Management

Auscap Long Short Australian Equities Fund

Newsletter – June 2019

Fund Performance*

Period	Auscap	All Ords
May 2019	3.8%	1.7%
Financial Year To Date	(6.2%)	7.3%
Since Inception	180.2%	89.0%
Annualised Returns	17.2%	10.0%

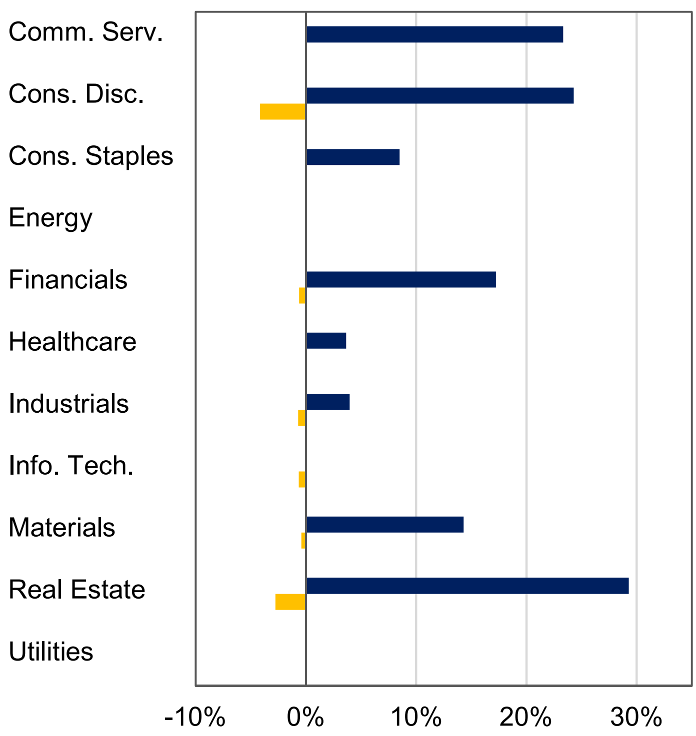
Fund Exposures

May 2019 Average	% NAV	Positions
Gross Long	124.7%	36
Gross Short	9.2%	10
Gross Total	134.0%	46
Net / Beta Adjusted Net	115.5%	104.0%

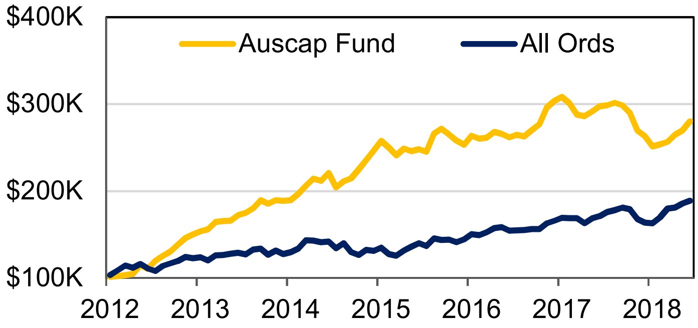
Portfolio Commentary

The Fund returned 3.8% net of fees during May 2019. This compares with the All Ordinaries Accumulation Index return of 1.7%. Average gross capital employed by the Fund was 124.7% long and 9.2% short. Average net exposure over the month was 115.5%. Over the month the Fund had on average 36 long positions and 10 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, consumer, communication services, financials and materials sectors.

Sector Exposure - May 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	(6.2%)
FY16	20.1%	CY19	11.4%

Top 10 Investments^

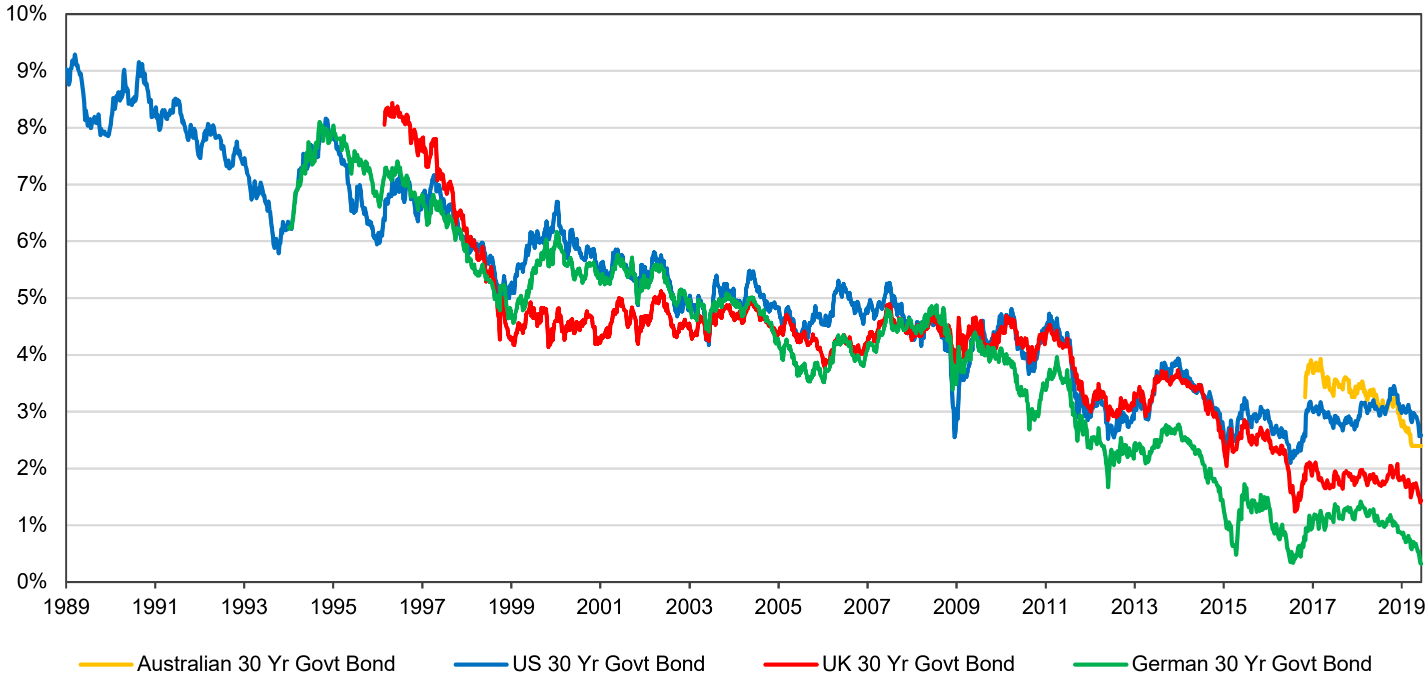
Adelaide Brighton	JB Hi-Fi
Blackmores	Mineral Resources
Centuria Metropolitan REIT	Nine Entertainment
CYBG	Super Retail Group
GDI Property Group	Westpac Banking Corp.

** 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 May 2019.

Should We Be Borrowing More?

At the time of writing, the ten-year Australian Government bond is yielding 1.37% and the recently offered 30-year Australian Government bond is yielding under 2.4%. This implies that the Federal Government can borrow money for 30 years and pay less than 2.5% on that borrowed capital. Australia is obviously not alone in having extremely low yielding Government bonds. The 30-year US Government bond yields a little under 2.6%. The 30-year UK Government bond yields less than 1.5%. The 30-year German Government bond yields 0.32%. Extraordinary. It raises an interesting question, at a time of somewhat anaemic global growth, why are governments around the world not taking more advantage of these incredibly unusual times to build valuable assets? After all, any asset that exceeds these measly costs of capital will have a positive net present value. In other words, government will be creating real value through such project developments.

Select 30 Year Government Bond Yields



Source: Bloomberg, Auscap

In the policy debate around fiscal stimulus, raising debt as a source of investment capital is often not distinguished from raising debt to pay for expenditures, but the two are very different. At the personal level, borrowing to buy an investment property that will produce income and likely increase in value over time is very different from borrowing to fund one's lifestyle. In the former, capital is allocated towards the development of a productive asset that will generate future cash flows. In the latter, once the money is spent only the debt remains. It is of course important for individuals and governments to live within their means and demonstrate over time that they can run a balanced budget where expenditure does not exceed revenue. But this is very different from a debate about whether governments should be borrowing to build assets. And at a time when the cost of capital is so low for national and state governments around the world, it is not difficult for asset development proposals to have prospective returns that exceed the meagre cost of government capital. To the extent assets are developed that generate earnings before interest and tax (EBIT), a reasonable rate of return would also imply these assets would be positively geared from completion. At a time when global growth is slower than it has historically been and there is an increasing focus on improving productivity, the range of projects worthy of consideration is high.

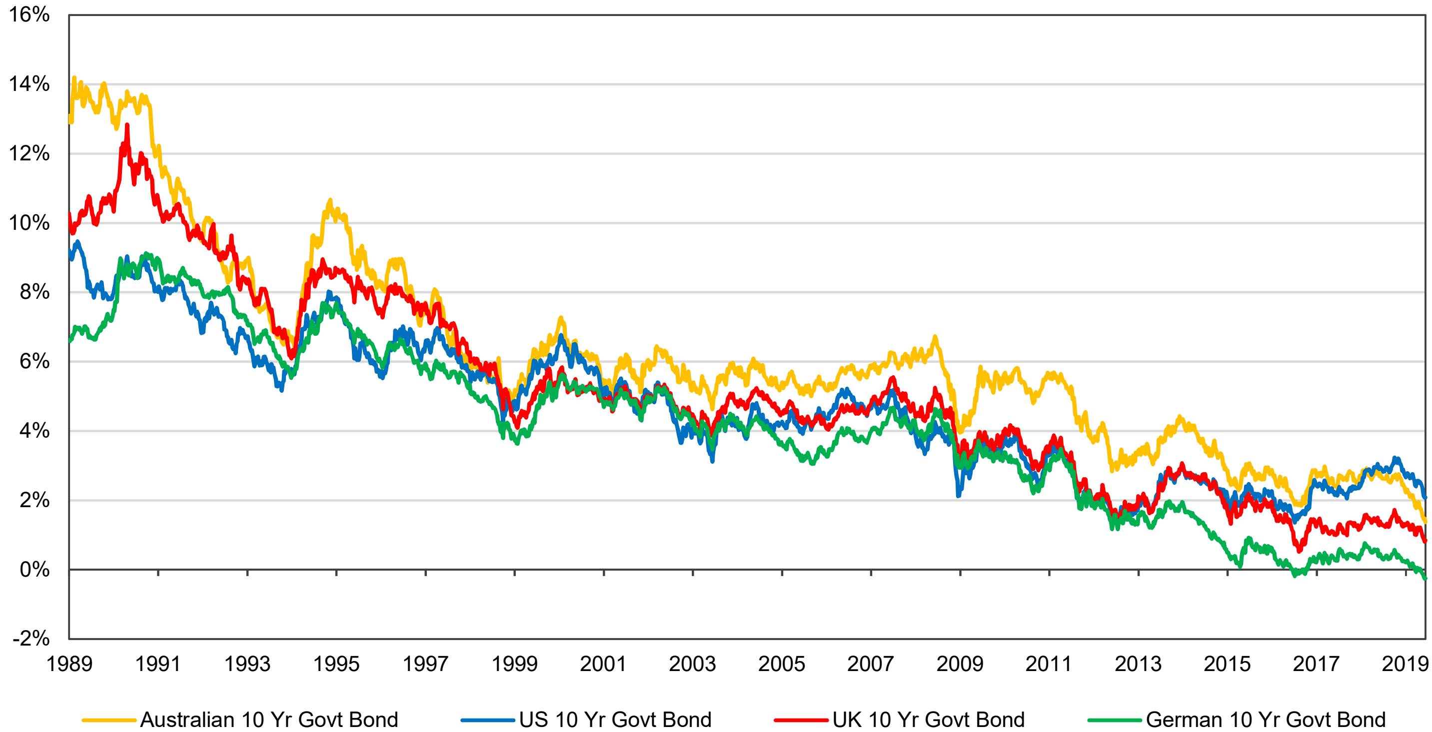
In Australia the Federal Government and many of our State governments are taking a proactive approach to building out infrastructure. In recent elections, the combined future infrastructure development commitments of the Victorian Labor Government, the NSW Liberal Government and the Federal Liberal Government were approximately $300bn. This promised expenditure primarily relates to transport infrastructure. A number of these projects are now financed off-budget, differentiating some investment from expenditure. Absent labour and skills shortages, there is no reason why such investment should not continue to grow. The demand for government bonds has never been stronger, reflected through lower yields, so the opportunity for value-adding developments is significant.

That prospective projects are, with independent verification, capable of generating a reasonable return is an appropriate test for whether such investments can be held off-budget. This will not always be the case. Some government investment can be considered sensible even where the direct return on capital is not apparent. The benefits might be spread across the community, resulting in efficiency and productivity gains that do not generate asset specific income. We are not suggesting that these assets should necessarily receive the same accounting treatment.

The "debt debate" and broad government reluctance to increase borrowings irrespective of purpose is best highlighted by frequent commentary about the need for governments to recycle capital should they wish to fund future investments. The implicit assumption is that all government debt is bad. In isolation such an argument does not seem to make much sense. If there is no constraint on the ability to raise capital, is there a need for a government to sell assets when they clearly have the lowest cost of capital of any investor group?

If the return on a particular asset exceeds its cost of capital, then the value created going forward will benefit its owner, so absent closed capital markets, where governments cannot raise the capital they require to initiate projects, it is an oddity that a government would choose to sell assets just to finance new projects. This involves selling assets at prices that meet the cost of capital of private investors, a figure that is well above their own cost of capital. So they will be selling at values below what those assets are worth to the government. Unless a government genuinely believes the productivity, efficiency and other benefits of private ownership in operating these assets outweighs the value loss, or the government was not in a position to increase its absolute leverage, it does not appear to make much sense to sell these assets at prices the private capital markets would be willing to pay. Simply put, the loss of income from the sale of the assets would exceed the saving made from the reduction in the interest expense on an asset that is increasing in value over time.

Select 10 Year Government Bond Yields



Source: Bloomberg, Auscap

More public awareness of the difference between debt that is borrowed for investment in income generating assets and debt that is used for expenditure might be one solution to government reluctance to borrow to invest for the future. Given the current cost of capital for all domestic governments, a continuing focus on building assets that generate an economic return that exceeds their cost of capital would appear to be logical and value creating.

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