## Auscap Long Short Australian Equities Fund

MARCH 2021

AUSCAP ASSET MANAGEMENT

# What Is Capital Preservation?

This newsletter coincides with the 100th month of operation for the Auscap Long Short Australian Equities Fund and the one year anniversary of the fastest significant sell-off from peak to trough in Australian capital markets history. Given this context, it seems like an appropriate time to discuss one of the most important topics in investing, capital preservation.

Capital preservation is an objective, not a strategy. Our two core aims when investing are to preserve capital and generate an attractive return on that capital. Whilst having a capital preservation objective is sensible, it is also widely held and in and of itself tells you very little about an investment manager. It is the approach to capital preservation that differentiates investment managers in respect of this objective. This newsletter discusses Auscap's approach to capital preservation.

Firstly, we focus on high quality businesses with sustainable competitive advantages, growth prospects, aligned management, strong balance sheets and clean financials. These businesses, whilst not immune to hiccups, tend to emerge from unforeseen economic shocks with an even more dominant market position. A sustainable competitive advantage might include:

- Scale advantages that result in a consistently lower cost of doing business such as superior buying power, a lower per unit corporate overhead cost and the capacity to spread investments over a larger revenue base;
- An entrenched customer base where the switching costs are considerable and the relationships are of long duration, making it able to withstand short term competitive pressure;
- A resource that has natural cost, product quality and/or transport and logistics advantages over peers; and
- Assets in monopolistic positions, such as major transport infrastructure within and between significant cities or shopping centres in irreplicable positions in major metropolitan precincts.

This list, while not exhaustive, covers a range of companies that we look to invest in. Businesses with competitive advantages tend to achieve superior returns on capital. This is logical. If a business truly has a competitive advantage, it should make more money for each dollar invested than its peers. This will be clear by analysing the return on capital metrics in the financial accounts of the business. The sorts of high quality businesses we are interested in investing in are those where we think a competitive advantage is enduring and the track record of strong returns on invested capital are therefore likely to continue into the future.

Secondly, we like to purchase stakes in these businesses when we think they are trading below our estimation of their worth. The purpose of buying below our valuation is simple, the valuation could be wrong! For example, the factors affecting a company's worth could change for the worse, rendering the assumptions used in the valuation less meaningful. Purchasing part of a business for less than we think it is worth provides a "margin of safety" for errors in analysis or worsening conditions. Negative surprises are inevitable, even for high quality businesses, but a focus on valuation aims to mitigate their impact.

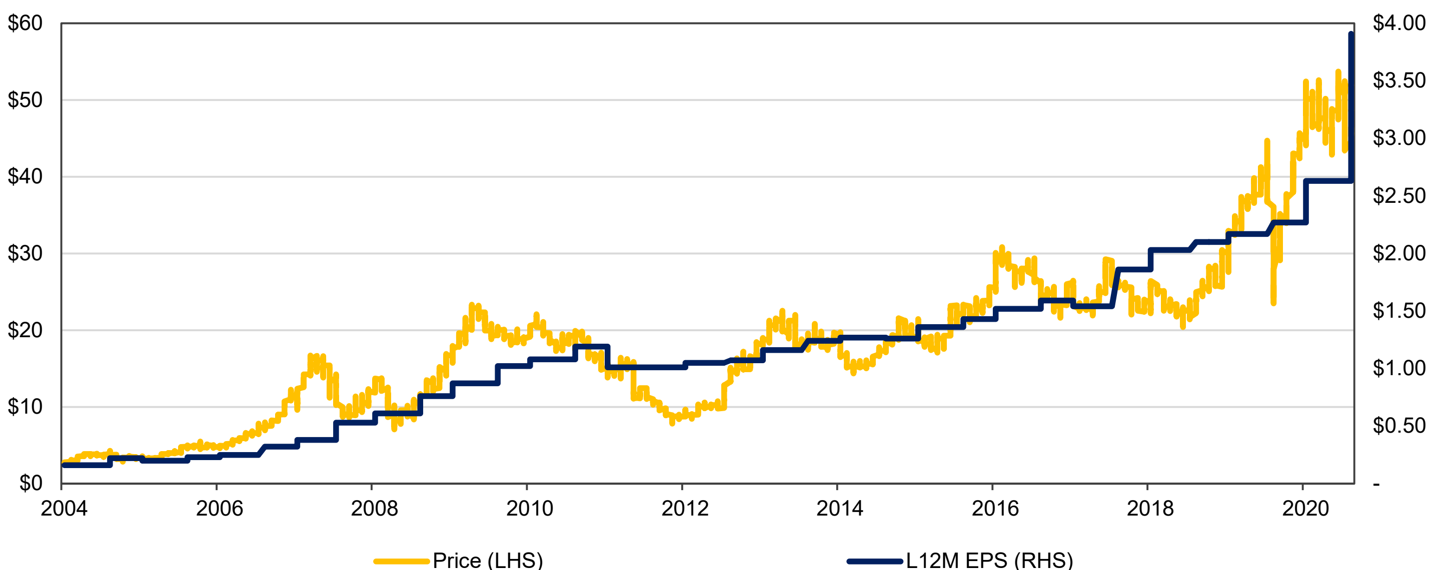
Of course, valuations depend on a number of inputs, with growth in revenue and earnings being critical factors. Due to the significance of compounding, the value of a predictably growing earnings stream from a business with a high return on capital should not be underestimated. So we are willing to and expect to pay more for profitable businesses that are growing reasonably quickly, if the measure of "paying more" is based on a multiple of its forecast near term earnings. This makes logical sense. To us, the objective of buying into companies for less than we think they are conservatively worth makes us a "value" investor. Whether companies are trading at low price to book and/or low price to earnings ratios, or have high current dividend yields, are not determining factors on their own. A low price to book ratio might simply reflect a company with a very poor return on capital which needs to constantly reinvest profits back into the business just to maintain profitability and so deserves to trade on a low price to book ratio. A low price to earnings ratio may reflect a declining business that could still be expensive on further analysis if earnings decline more quickly than the market is factoring in. A high dividend yield may reflect an unsustainable payout of cash flow that will diminish over time. An approach defined by buying these sorts of companies could be more typically categorised as deep value, an approach that we tend to avoid.

We are however cautious about forecasting many years of exceptional growth, particularly for businesses that are currently unprofitable or barely profitable. Experience tells us that it is difficult for a company to grow quickly for many years without interruption, and the number of companies that achieve this feat are few and far between. There are often disruptive events, new competition, changing regulations or other adverse events that interrupt rapid growers at one stage or another. So paying up based on the assumption of continual rapid growth rarely provides us with a sufficient margin of safety to be comfortable.

We believe the best way to preserve capital *over time* is to buy high quality businesses with a sustainable competitive advantage at a discount to our calculation of what we think they are worth. We have highlighted two words in this statement, “over time”. The obvious question is over what time? What is a reasonable period of time to expect performance? And should such an approach result in reasonably linear performance, or will there be cyclicality, meaning times when it works well and other times when it works less well?

Clearly we have no predictive power over daily share price fluctuations. So expecting performance over a short time horizon is a folly. Companies can be out of favour for no reason of their making for a number of years. JB Hi-Fi is one of the lowest cost of doing business electronics retailers in the world. It has a leading brand, operates in a growing industry and has a very powerful market position in Australia. It has been a Fund holding for many years. From mid 2016 to early 2019 its share price declined from over $31 to under $21, a frightful performance for anyone with a short term horizon. What had gone drastically wrong? Precisely nothing. They grew earnings per share substantially during this period.

**JB Hi-Fi Earnings Per Share and Share Price**




Source: Factset, Auscap

JB Hi-Fi were responding to the opportunity and threat of e-commerce with vigour, a battle for which they continue to look well positioned. But the threat of Amazon and other online players, the presumed impact on consumption from a decline in the residential property market, the structural decline in DVD sales and the perceived integration risk around the acquisition of The Good Guys saw pessimism increase to a peak in early 2019. But eventually earnings dictate share prices. The stock moved quickly from $21 to over $41 by early 2020.

Warren Buffet has called the stock market “*a device for transferring money from the impatient to the patient.*” The suggested time horizon many seasoned professionals have for equities is at least 5 years. Our intended time horizon for holding businesses is many, many years. Market sentiment can remain negative for substantial periods of time, even as a business continues to develop, invest and grow earnings.

It is our intention to preserve capital through our approach to investing. This is *how* we preserve capital. We also selectively short businesses that we consider to be considerably overvalued with medium term downside to earnings forecasts. In aggregate we have always run a considerable net long portfolio, so these shorts are not designed to hedge the portfolio because we want long term exposure to great businesses.

We do not try to supplement this approach with any fancy short term "trading" strategies. We have no advantage in guessing where the market might head on any given day, week or month, so trying to guess our way to short term profits in our view is not only impossible but more likely to lead to short term losses than gains, consuming important mental capital in the process.

Importantly, our approach to preservation of capital has not mentioned volatility. We do not specifically aim to minimise volatility. We do not aim to keep the Fund's volatility at a particular level or in line with a basket of stocks such as an index. We are generally sceptical of the merits of using historical share price volatility as a proxy for risk. Investors want a measure of riskiness and, in the absence of anything better, often measure volatility because it is measurable! It reminds us of Albert Einstein's quote, "*not everything that can be counted counts and not everything that counts can be counted.*" The problem is, while some extremely volatile instruments are definitely risky, volatility is not a sufficient condition for something to be risky. At moments of extreme value, investments often exhibit extreme volatility. Equities in March 2020 were the least risky they had been for some time and were offering incredible value, despite the extreme volatility that they were exhibiting. So in such an instance, high levels of volatility do not equal high levels of risk. The same could be said for investing in high quality businesses after every major market fall. Yet if volatility was used as a benchmark, high quality stocks would be considered extremely risky at these points in time. So targeting volatility is very likely to not be the same as minimising or even managing risk, since volatility is an outcome, and one that does not necessarily correlate with risk.

One easy way to minimise volatility is to reduce exposure. Whilst an investment in cash carries minimal volatility, it carries little or, in the current environment, no reward. But this defeats the purpose of investing in equities. If one was trying to keep volatility constant over time, then one would be inclined to have the smallest exposure when stock price volatility is highest, after large market falls, when the most compelling value is on offer. Similarly, one would often have the highest exposure to equities when markets are sanguine and complacent about risk, typically after strong upward moves when value is least compelling. So targeting a level of volatility can also be counter-instructive to deliver capital preservation.

Another alternative is to seek volatility that is similar to an index. The inevitable result of such targeting is fairly logical, to have the volatility of an index a fund must look similar to that index. This leads to managers seeking to resemble the index in at least the sectoral composition of their portfolio, and often in relation to the biggest weights in the index in particular, irrespective of whether value is on offer in these names. This is perhaps not surprising given the asymmetric risk for managers in delivering returns that are differentiated from the market. The reluctance to deviate too far from the mean in terms of performance or volatility results in "index hugging", where the manager largely replicates the index while hoping that a small number of stock picks will generate enough alpha to drive outperformance. This is a difficult feat to achieve after fees, and the majority of managers taking this approach will struggle to achieve this delicate balance. It also throws up an obvious problem, that a stock that has a large index weighting is dangerous to such a manager if it does particularly well and the manager does not own it. This can lead to ownership for reasons that have nothing to do with fundamentals. And invariably the entire exercise can lead to justifiable criticism that this sort of investment management is not genuine active investing.

We ignore the composition of the market given it should have little bearing on our view as to where the best opportunities lie, what the best risk adjusted portfolio might be or which sectors we should be overweight. We do not have any perceived view that the Fund's volatility should be greatly above or below the market, but over time we expect our returns to be in excess of the market, since we are focused on finding the best risk adjusted returns through a superior quality portfolio purchased at attractive prices. To date the Fund has delivered 15.9% per annum post fees over the last 8.25 years. Over that same period the All Ordinaries Accumulation Index has returned 9.6% per annum.

The nature of this concentrated and active investment approach is that there will be periods when the Fund is both more volatile and less volatile than the All Ordinaries Accumulation Index, its benchmark. Volatility in and of itself is only the same as risk to the extent it is acted on to the detriment of the investor. We continue to be of the opinion that we own market leading businesses. They will survive and thrive through crises. So the risk of us liquidating investments when great value is on offer is extremely low, unless done to optimise the portfolio and facilitate buying in even more compelling opportunities. Investing is always a relative proposition. Better opportunities should be prioritised.

As discussed above, Auscap's objective isn't to just buy the cheapest stocks on offer, we are focused on value and quality. On that front we intend to continue to work on improving our communication with our investor base. From this month we will disclose the top 20 positions in the portfolio. This is to continue the journey of improving transparency so that investors are increasingly familiar with the sorts of companies we are invested in. We also intend to introduce a more comprehensive quarterly newsletter that will generally be more focused on stock investments than the monthly newsletter, and reduce the detail in the monthly newsletter to a performance fact sheet. The objective is to have our commentary more focused on our long term thinking, and less on the regular news reporting required by monthly analysis. Our investment timeframe is long term, and we hope that our investors will benefit from more detailed analysis delivered slightly less frequently. All past newsletters will continue to be available on the website. As always, we encourage any feedback on these developments.

# Auscap Long Short Australian Equities Fund

## Fund Performance*

| Period | Auscap | All Ords |
|---|---|---|
| February 2021 | 3.4% | 1.4% |
| Financial Year To Date | 56.0% | 17.7% |
| Since Inception | 239.0% | 113.7% |
| Annualised Returns | 15.9% | 9.6% |

## Fund Exposures

| February 2021 Average | % NAV | Positions |
|---|---|---|
| Gross Long | 132.4% | 52 |
| Gross Short | 6.7% | 2 |
| Gross Total | 139.1% | 54 |
| Net / Beta Adjusted Net | 125.7% | 147.4% |

## Portfolio Commentary

The Fund returned 3.4% net of fees during February 2021. This compares with the All Ordinaries Accumulation Index return of 1.4%. The Fund's biggest exposures over the month were spread across the consumer discretionary, real estate, materials, financials and communications services sectors.

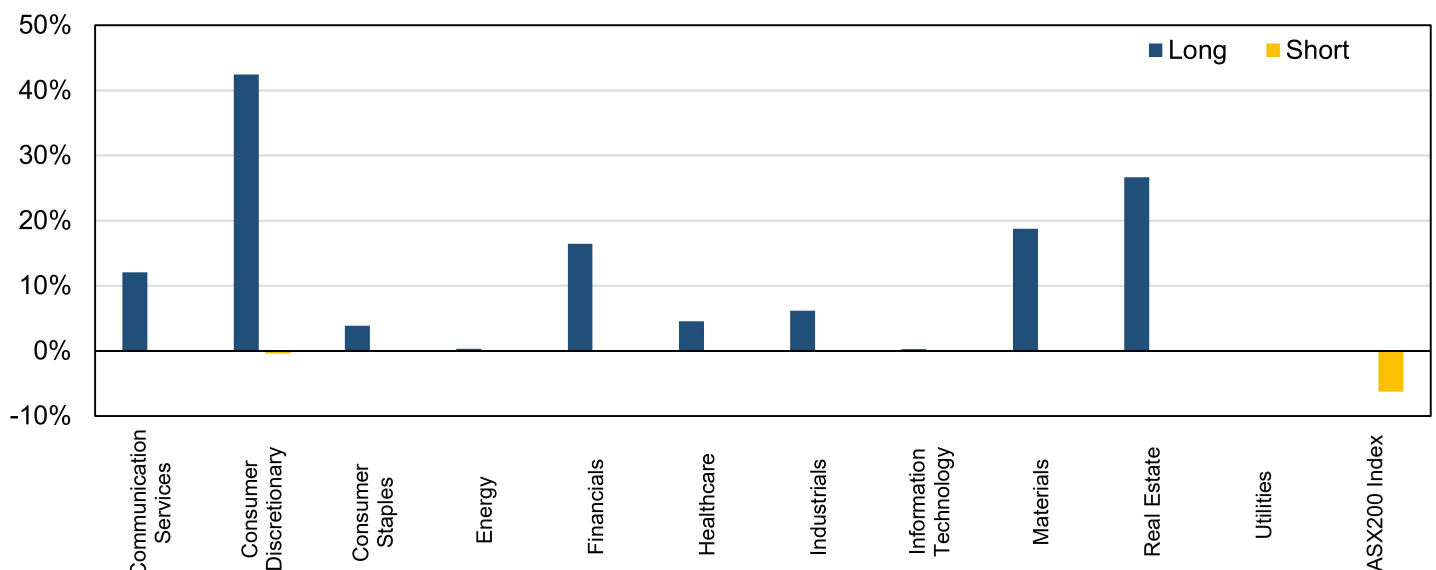
## Fund Calendar Year Returns*

| | | | |
|---|---|---|---|
| CY13 | 51.9% | CY18 | (18.5%) |
| CY14 | 23.2% | CY19 | 18.1% |
| CY15 | 36.0% | CY20 | 10.6% |
| CY16 | 2.2% | CY21 | 3.3% |
| CY17 | 17.1% | | |

## Top 20 Investments

| | |
|---|---|
| Atlas Arteria | Mineral Resources |
| Aventus Group | Motorcycle Holdings |
| Blackmores | Nick Scali |
| Carsales.Com | NZME |
| Charter Hall Retail REIT | Reece |
| Eagers Automotive | Rio Tinto |
| GDI Property Group | Super Retail Group |
| Home Consortium | Unibail-Rodamco-Westfield |
| Jumbo Interactive | Virgin Money UK |
| Macquarie Group | Virtus Health |

## Sector Exposure - February 2021




*Performance figures are calculated for the Monthly Class net of all fees and expenses assuming the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.*
*^ Top 20 long investments in alphabetical order as at 28 February 2021.*

# Newsletter – March 2021

Auscap Asset Management

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