Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – July 2013

© Auscap Asset Management Pty Ltd

***Disclaimer:** This newsletter contains performance figures and information in relation to the Auscap Long Short Australian Equities Fund from inception of the Fund. The actual performance for your account will be provided in your monthly statement. Actual performance may differ for investments made in different classes or at different times throughout the year. This newsletter is intended to provide general background information only. It is not a Product Disclosure Statement under the Corporations Act 2001 (Cth), nor does it constitute investment, tax, legal or any other form of advice or recommendation to be relied upon when making an investment or other decision. Past performance is not a reliable indicator of future performance. While all reasonable care has been taken to ensure that the information in this document is complete and correct, no representation or warranty is given as to the accuracy of any of the information provided, including any forecasts. To the maximum extent permitted by law, Auscap Asset Management Pty Ltd ACN 158 929 143 AFSL 428014, its related bodies corporate, directors, employees or representatives are not liable and take no responsibility for the accuracy or completeness of this document. No investment in the Fund should be made without fully reviewing the information, the disclosures and the disclaimers contained in the Information Memorandum or any supplement to that document.*

Welcome

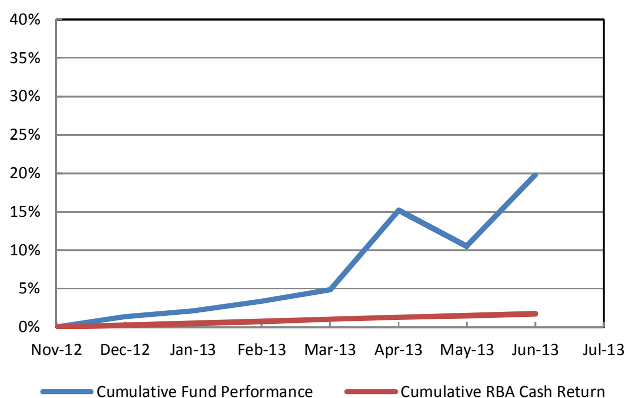
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we look at the "expensive defensives", companies with earnings that are less cyclical in nature and typically offer lower growth than the broader market, that are characterised as having share prices that exceed analyst valuations. We offer an alternative hypothesis to the argument that suggests selling these recent outperformers.

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 8.32% net of fees during June 2013. This compares with the benchmark return of 0.23%. Average gross capital employed by the Fund was 172.5% long and 55.7% short. Average net exposure over the month was +116.8%. At the end of the month the Fund had 25 long positions and 15 short positions. The Fund's biggest exposures at month end were spread across the consumer discretionary, financials, healthcare, telecommunications, utilities and materials sectors.



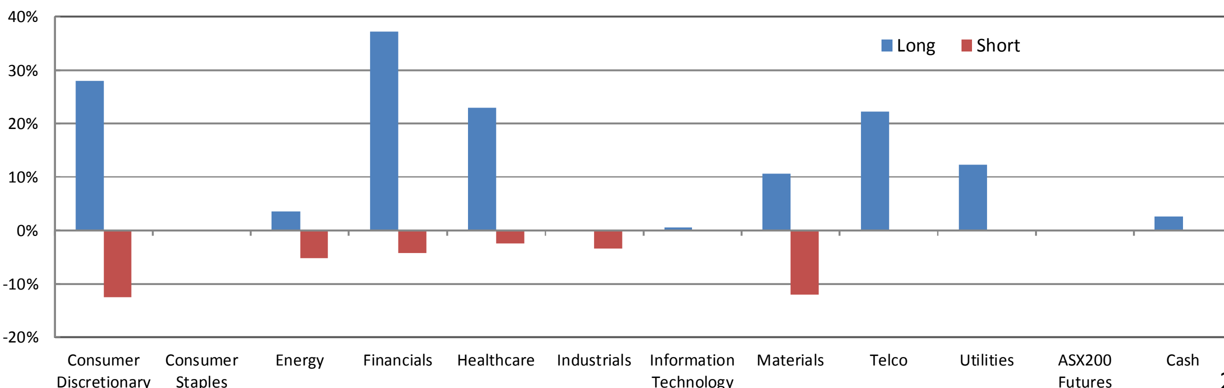
Fund Returns

Period	Auscap	Benchmark
June 2013	8.32%	0.23%
Financial Year to date	19.72%	1.72%
Since inception	19.72%	1.72%
Unit Price	1.1972	1.0172

Fund Exposure

June 2013 Average	% NAV	Positions
Gross Long	172.5%	28
Gross Short	55.7%	19
Gross Total	228.2%	47
Net	116.8%	

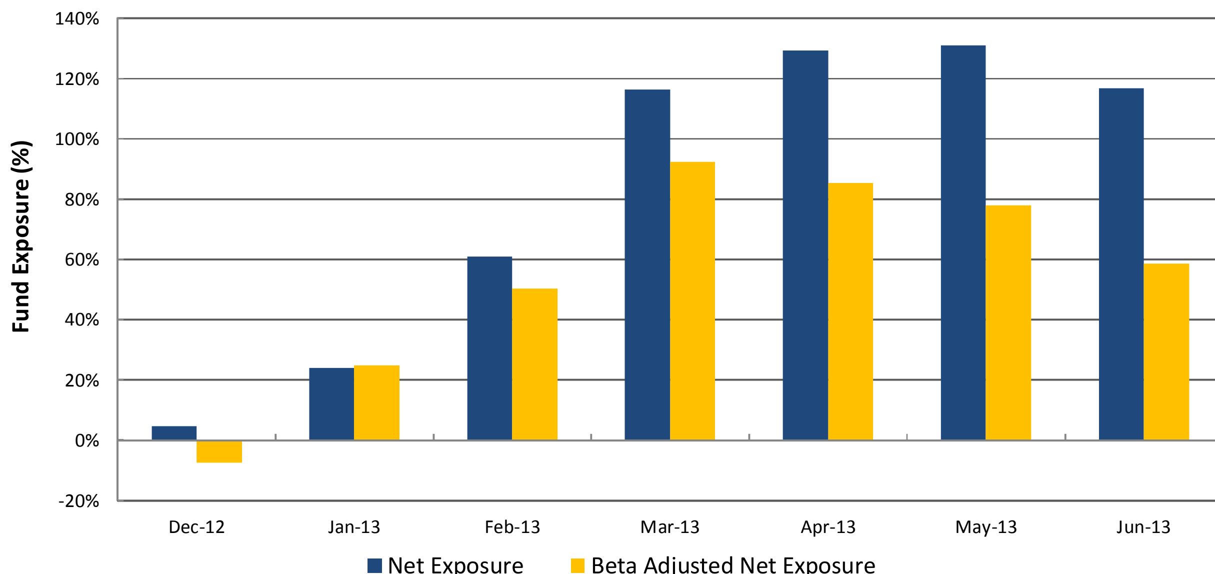
Sector Exposure - 30 June 2013



Expensive Defensives – Do They Deserve The Tag?

The so called "expensive defensives" performed relatively well in a market that fell in June, with the All Ordinaries Accumulation Index down 2.5% over the month. The Fund has long term positions in a number of companies that may be considered to fit this description, albeit we have a different view on whether these companies are in fact expensive. In this edition we discuss our theoretical argument as to why we consider these companies to be fair value at current prices in an economy that we think is likely to be characterised by lower growth and broadly disappointing earnings over the next few years.

But before we get into that debate, we thought it worthwhile to have a brief discussion on risk and return. The Fund had an unusually strong month in June, perhaps somewhat surprisingly given the Fund was on average more than 100% net long over the course of the month. It points to the potentially misleading simplicity of evaluating risk by analysing net exposure alone. In fact, internally at Auscap we look at many risk measures to understand the risk to capital from the Fund's exposures. Preservation of capital is always our first priority. One measure that we think more accurately portrays the Fund's net exposure to broad market movements is the beta-adjusted net exposure, which adjusts the delta of a position according to a stock's beta[i]. During June, because our long exposures were predominantly defensive and our short exposures were more cyclical and higher beta in nature, our beta adjusted net exposure was 59%, significantly lower than the unadjusted net exposure of 117%. The Fund's beta adjusted net exposure has been significantly lower than the unadjusted net exposure since the start of the Fund.



In this context, the returns for the Fund were strong in a volatile month for the market. The defensive stocks that we hold moved slightly higher, in aggregate, over the course of the month, adding 1.1% to post fee returns. Some of these stocks also paid a semi-annual dividend which added a further 2.1% to Fund performance during the period. However, the majority of the returns were generated by the shorts that we use to hedge the portfolio. In particular, the Fund had a diverse range of shorts in the materials and mining industrials sectors which added 3.2% and 2.2% respectively in post fee performance for the month. These were effective but not particularly large positions, averaging less than 2% of Funds Under Management on an individual position basis and less than 30% in aggregate. Remaining positions detracted 0.3% from returns. We would caution against extrapolating the returns delivered during the month because of the significant moves in some of the positions held. That said we are still confident in the stocks that we are invested in. Some of these are "expensive defensives" although we are not convinced the classification is warranted.

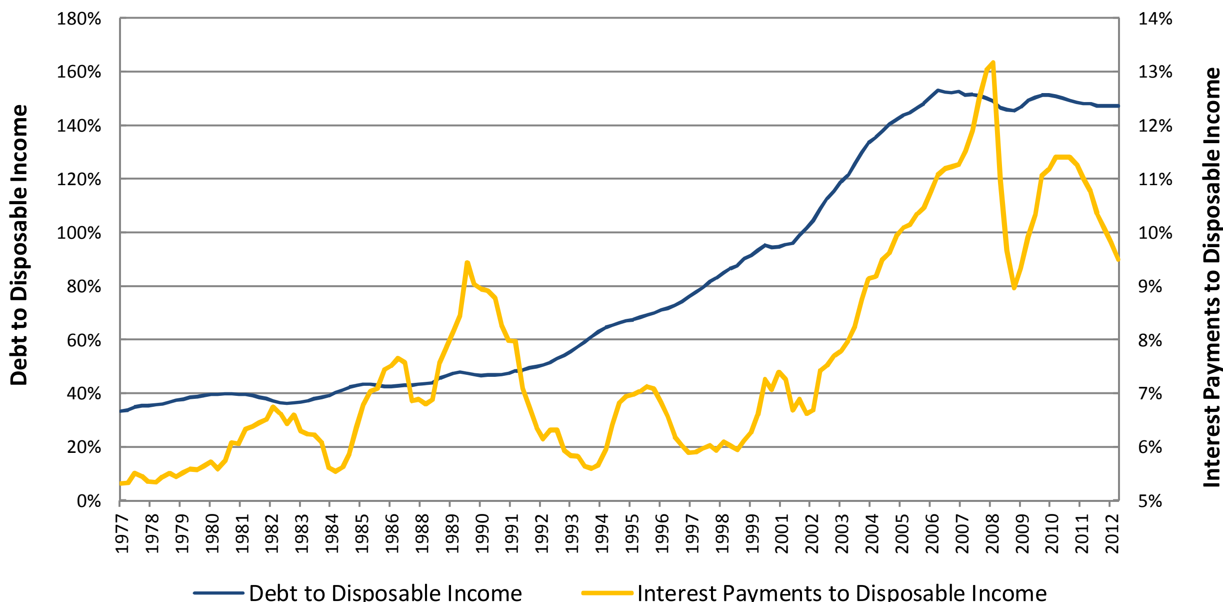
The Debate

There has been significant discussion about the outperformance of companies with a good dividend yield in defensive sectors over the past few months. These are companies that have, broadly speaking, reliable and consistent earnings with modest growth expectations. Their earnings tend to be resilient in a deteriorating economic environment. On the flipside they are generally unable to grow earnings as strongly as other companies in an expanding economy. These are the companies in the telecommunications, consumer staples, utilities and property trust sectors. The bears would suggest that the likes of Telstra, Woolworths and Westfield Retail Trust are expensive on a Price to Earnings or Price to Book basis. We want to take a look at this debate and offer an alternative perspective.

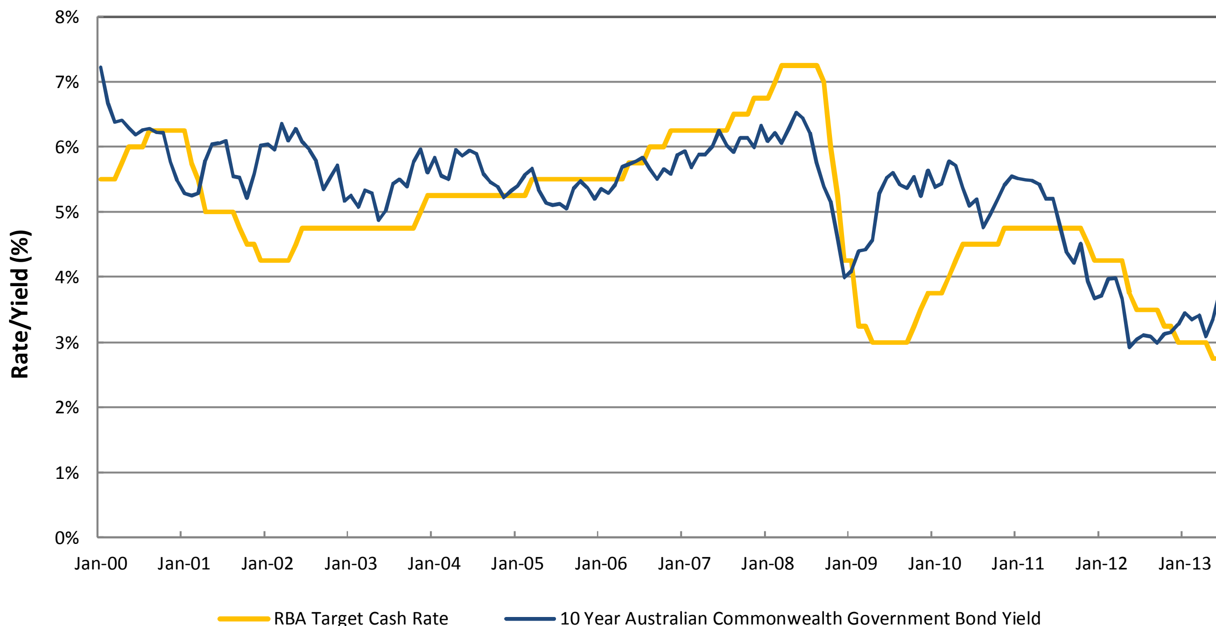
Low growth = Low interest rates

When analysing the macroeconomic environment, we try to focus on what we think can be determined with reasonable accuracy, not on what might or might not happen in volatile markets. What we see is a world that has an ageing population in many developed and some very important developing markets. We see government debt at levels that focus attention on the need to bring national balance sheets under control. We see imbalances in some of the economies that have been driving world growth. Ultimately we think this means the world is going to experience low levels of growth in the coming years. The world's baby boomers have gone from asset accumulation and increasing leverage to a period of post retirement spending and economic deleveraging. Nowhere does that appear more the case than in Australia.

Over the last decade Australia has enjoyed the economic tailwinds of a once in a century commodity boom. As the investment peak passes and commodities return to their marginal cost of production, real GDP growth over the next five years is likely to be significantly lower than that experienced in the last decade. In an attempt to stimulate growth in the eastern states and reduce the fallout from a natural slowdown in mining capital expenditure and lower commodity prices, we think it is highly likely that the RBA will keep interest rates lower for longer. We do not think it is the availability and cost of credit that is preventing Australians from borrowing more, we think it is an increasing aversion to having significant levels of personal and household debt. The cost of servicing household debt may be falling, but debt as a percentage of household income is at reasonably elevated levels.



If interest rates remain lower than where they have been historically, the yield that investors receive on Australian Commonwealth Government Bonds is also likely to remain lower. The current RBA Target Cash Rate and expectations for changes in the Target Cash Rate are the main determinants of the yield on Australian Commonwealth Government Bonds.



That is not to suggest that Australian bond yields are not affected by the pricing of bonds globally. Indeed there may be short term implications from movements in interest rates and bond yields in the US, Europe and Asia. However, we are of the view that we expect the world to continue to experience low growth and fiscal austerity. Higher rates naturally have the effect of reducing growth by increasing the cost of finance. We do not think growth will be strong enough in the near term to sustain materially higher rates in the developed world. Ultimately, we think that Australian rates will move in accordance with the domestic economic outlook, which is more dependent on growth in China than the other major economies.

The effect of lowering the risk free rate

The Required Return on Equity is the return on an investment in equities that is required to induce investors to purchase such securities. It is a function of the risk free rate and a risk premium, the additional return required to compensate investors for holding an asset with more risk to earnings and capital than a risk free asset.

Required Return on Equity (r_e) = Risk Free Rate (r_f) + Risk Premium (r_p)

If interest rates remain lower over the coming years than where they have historically been, this reduces the attractiveness of cash and bonds as an alternative asset. Theoretically, from an equities standpoint, we think it has the effect of lowering the risk free rate used to value a company's future earnings.

The risk free rate used by the financial community is typically the return offered by a long term government bond. The 10 year Australian Commonwealth Government Bond yield hovered between 5% and 6% for the majority of the decade from 2000 to 2010. If we assume that growth remains lower in coming years than what we have experienced in the last decade, the yield on the 10 year Australian Commonwealth Government Bond is highly likely to be lower than its historical average. This has the effect of reducing the effective return offered by "risk free"assets. Lowering the risk free rate reduces the required return on equity.

Impact on Valuation

The Gordon Growth or Dividend Discount Model gives us a simple way of understanding the impact on valuation from a reduction in the required return on equity.

$$\text{Share Price} = \frac{\text{Dividend x (1 + growth rate)}}{\text{(required return on equities – growth rate)}}$$

Let us assume that the dividend approximates the company's earnings. This applies ordinarily to low growth companies, the "expensive defensives", who are not undertaking major capital projects. It should also apply to cyclical stocks as an economy moves into an anticipated downturn, where they should be returning capital to shareholders rather than investing in new capacity increasing expansion projects. Rearranging the equation above and replacing Dividends with Earnings gives us the following equation.

$$\text{Price / Earnings} = \frac{\text{(1 + growth rate)}}{\text{(required return on equities – growth rate)}}$$

As the matrix below demonstrates, if we reduce the required return on equities, the impact on valuation is positive and hence the stock should trade on a higher Price Earnings multiple. Intuitively, if you lower the returns offered by alternative asset classes, then in a relative sense equities become more attractive. We know this from investor behaviour. When term deposit rates were at 6%, the market multiple was substantially lower because of the fact that investors could receive such a strong rate of return in a largely risk free asset. As deposit rates have fallen, the market has risen, repricing the required return on equities as alternative asset returns fall.

However, the reason the risk free rate is lower is because growth is slower. If the broad economic growth rate is expected to be lower by the same degree, the market should trade on the same multiple, corresponding to a move from A to C in the table below.

Price Earnings Multiples Using Different Long Term Assumptions

Required Return on Equities	Nominal Earnings Growth Rate: 0%	1%	2%	3%	4%	5%	6%
8%	12.5x	14.3x	16.7x	20.0x	25.0x	33.3x	50.0x
9%	11.1x	12.5x	14.3x	16.7x	20.0x	25.0x	33.3x
10%	10.0x	B 11.1x	12.5x	C 14.3x	16.7x D	20.0x	25.0x
11%	9.1x	10.0x	11.1x	12.5x	14.3x	16.7x	20.0x
12%	8.3x	9.1x	10.0x	11.1x	12.5x	14.3x A	16.7x
13%	7.7x	8.3x	9.1x	10.0x	11.1x	12.5x	14.3x
14%	7.1x	7.7x	8.3x	9.1x	10.0x	11.1x	12.5x

Slower Growth is Not Uniform

However, slower growth is not uniform across sectors and across companies. Typical 'growth' or 'cyclical' industries will find it more difficult to grow at historic rates in a low growth environment. In fact, during an economic slowdown, many of these companies may have no or even negative growth in earnings over the medium term, and de-rate from 14x (A) to a lower multiple (B). Unfortunately, often the market has lofty expectations for growth up to and until these expectations become clearly incorrect. As we explained in our June Newsletter, we believe the expectations for earnings growth across the companies within the ASX200 are too high for FY14.

By contrast, the defensive companies do not experience the same headwinds to achieving their smaller growth targets, which are generally in the order of 1-2% more than inflation, roughly equivalent to the rate of domestic population growth. To the extent their growth profile does not change significantly with the broader economy, we think they should trend towards trading on higher multiples. They offer bond like returns to some degree, and should re-rate if bond yields stay lower for longer (potentially moving from A to D).

It is interesting to note that this is what has happened in the US, where bond rates have been significantly lower than in Australia for a number of years. Companies in defensive sectors that are seen as bond proxies, such as the largest REIT in the US market, Simon Property Group, have re-rated as US bond yields have fallen. Simon Property Group owns, develops and operates retail real estate properties including regional malls, outlet centres, community centres and other properties. It is similar to Westfield Group in many regards. However, it currently trades on a 37.5x Price/Earnings multiple and a 3.1% dividend yield. By comparison, Westfield Holdings trades on a 16.2x Price/Earnings multiple with a 4.7% dividend yield.

	Westfield Group (AU)	Simon Property Group (US)
FY14 EBIT	$2,225m	$2,569m
FY14 Net Income	$1,473m	$1,370m
Market Capitalisation	$24,581m	$50,539m
Net Debt	$12,071m	$24,610m
Enterprise Value	$36,652m	$75,149m
FY14 Dividend Yield	4.70%	3.11%
10 Year Govt Bond Yield	3.75%	2.53%

* Source: Bloomberg estimates 17 July 2013

There are limitations to the simplicity and our application of the Gordon Growth model, however we do think it provides some basis for the market's current appreciation and demand for defensive stocks that are likely to grow earnings, even in a difficult economic environment. Far from proving expensive at current levels, we think there is logic behind why these defensive stocks may trade on higher multiples in the future as the headwinds facing many of the other sectors in the economy become increasingly obvious and earnings disappoint investors.

Ultimately we hold positions in high quality companies with growing earnings because we think they represent value in absolute terms for investors. We think a company that provides a 6%+ often fully franked dividend yield that is likely to grow earnings at a rate that exceeds inflation will, over time, prove a good investment in a low growth environment.

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.

Auscap Asset Management

ACN 158 929 143 AFSL 428014
Lvl 24, 9 Castlereagh St, Sydney
Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
Administration: White Outsourcing
Tax & Audit: Ernst & Young
Legal: Henry Davis York

[i] Beta represents the volatility of an asset in relation to the benchmark the asset is being compared to, in this case the All Ordinaries Accumulation Index.