Auscap Long Short Australian Equities Fund Newsletter – February 2015

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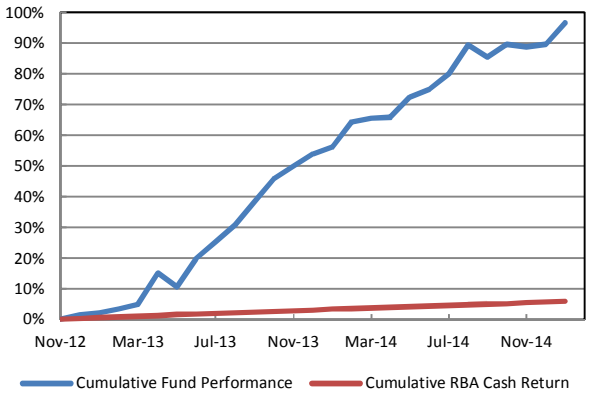
Welcome

Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (ñFundò) 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 what we think is a common misinterpretation of the conventional thinking that young people should seek higher risk investments.

Fund Performance

The Fund returned 3.65% net of fees during January 2015. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 109.9% long and 25.2% short. Average net exposure over the month was +84.7%. At the end of the month the Fund had 27 long positions and 10 short positions. The Fundôs biggest stock exposures at month end were spread across the financials, consumer discretionary, healthcare, materials and energy sectors.



Fund Returns

Period	Auscap	Benchmark
January 2015	3.65%	0.21%
Financial Year to date	12.44%	1.46%
Calendar Year to date	3.65%	0.21%
Since inception	96.56%	5.85%

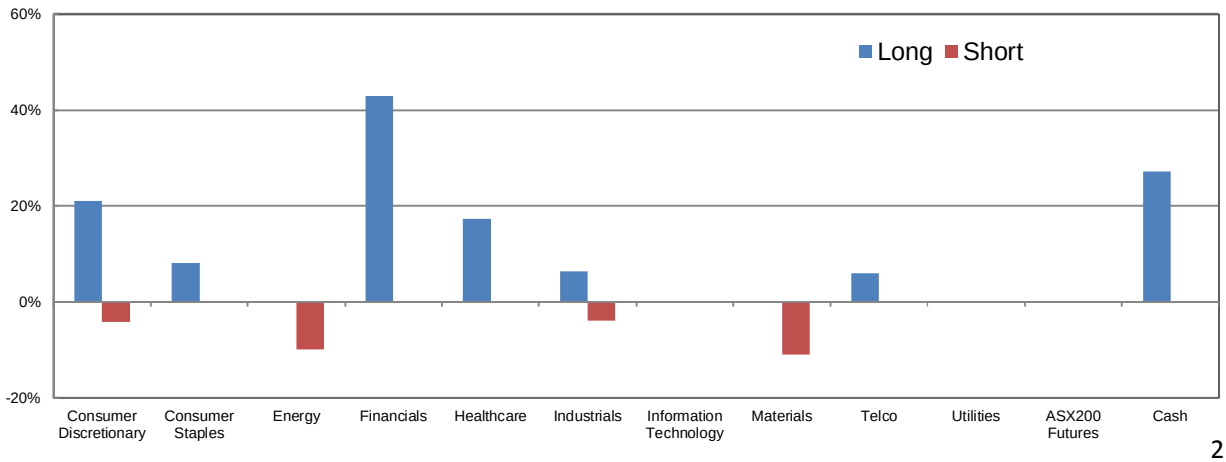
Fund Exposure

January 2015 Average	% NAV	Positions
Gross Long	109.9%	29
Gross Short	25.2%	10
Gross Total	135.1%	39
Net / Beta Adjusted Net	84.7%	53.3%

Fund Monthly Returns

Year	Jul %	Aug %	Sep %	Oct %	Nov %	Dec %	Jan %	Feb %	Mar %	Apr %	May %	Jun %	YTD
FY13						1.35	0.74	1.23	1.46	9.83	(4.05)	8.32	19.72
FY14	4.70	4.28	5.84	5.46	2.86	2.57	1.32	5.32	0.70	0.29	3.82	1.48	46.01
FY15	2.95	5.24	(2.09)	2.25	(0.43)	0.44	3.65						12.44

Sector Exposure - 31 January 2015



The Opportunity Cost Of Risk-Seeking Behaviour

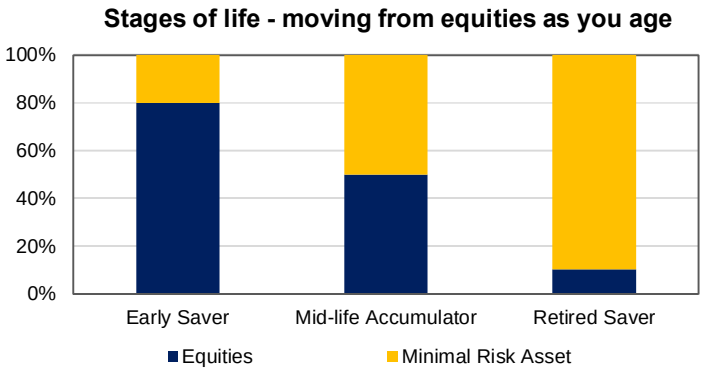
During a recent discussion with an institutional equities broker, a person who advises professional fund managers on which stocks to buy and sell, the conversation gradually drifted from which stocks the broker recommended for our fund to those that he thought might be more appropriate for the ñPAò (Personal Account) portfolio. While the fact that there was a distinction made might seem curious to the casual observer, this distinction is not an uncommon one for many knowledgeable and experienced financial markets professionals. The broker wanted to ñhave a goò in his personal portfolio, albeit he recognised immediately that the penny dreadful stocks he was talking about were not suitable for a portfolio managed for the long term benefit of others. These stocks were certainly not investment grade, which one could interpret as ordinarily having no meaningful or near term profitability or positive cash flow, making valuation an impossible task that sat somewhere between future guesses and mere speculation.

This attitude towards risk appears pervasive in the market, particularly amongst younger participants. It says something of the innate human desire to ñhave a puntò, to gamble, to want to engage in risk-seeking (rather than return-seeking) behaviour. To some it *appears* that financial academia has provided a logical basis for pursuing what are obviously higher risk investments. The suggestion is that in a personôs life cycle they should be more tolerant of risk when youthful to try and achieve higher returns because one can ride through periods of volatility. Early in a personôs career they have less immediate need to access any accumulated capital (savings) since they are fully employed wage earners, and they can therefore see through periods of turbulence without needing to realise part of a portfolio at a loss to pay for living expenses. Therefore if higher returns from a particular asset class, such as equities, are expected over the medium term, this person should have a higher exposure to this asset class.

One popular age-based guide to investing in equities is:

Allocation To Stocks (%) = 100 – Age

Of course there are many variations on this theme, as the graph on the right displays. All make the same assumption, that people should have higher risk tolerance when they are young and have plenty of working years ahead.



The problem, as is often the case, is not in the theory but in the interpretation. Many people use this guidance as a justification to take on more risk, which in and of itself certainly does not guarantee (or really have anything at all to do with) higher expected returns. ñAn increased allocation to asset classes with higher expected returnsò becomes confused and seemingly replaceable with statements such as ñI have a long time to earn the money back should I lose itòand ñthis money is not life-changing now but what if I made 20 times on this stockò. Selective memory bias about oneôs past successes in picking huge winners (that unfortunately werenôt backed ñPAò because of the *risk* involved) convinces the market participant that they should invest (or, in reality, speculate) heavily in the next potentially big thing they see, this time ignoring the risk component.

Taking on more risk is not a guarantee for higher overall returns. In fact, we would suggest the opposite is almost certain to be true in most circumstances because of the variance involved in potential outcomes. Taking on more risk just means taking on more risk. Achieving superior returns depends on oneôs ability to understand the relationship between risk and return, trying to maximise long-term returns without significantly moving up the risk curve. This is a difficult exercise, just ask any fund manager!

The research into portfolio allocations focuses on the long-term performance of equities indices, concluding that the broader market has higher volatility than other investable asset classes but also higher long-term returns. These indices, however, are dominated by large investment grade companies. Nowhere in the research is it suggested that a smorgasbord of significantly higher-risk, small-cap, cash-hungry speculations lead to expected returns that are higher or even in line with the broader market averages. In fact, as outlined in the Auscap September 2013 Newsletter titled *"Risk and Reward: The Case for Size and Liquidity"*, there is evidence to suggest that the best risk-adjusted returns come from large and mid capitalisation stocks.

When the discussion with this broker turned to the performance of his PA portfolio we discovered that one of the five stocks he held was already down close to 50% from purchase only a few months ago, and the remaining positions were marginally up or down leading to what we suspected must be a negative total return result. There was no indication however that the broker was prepared to give up on his strategy, despite this strategy being a well-trodden path (even to him!) with a predictable final outcome, being the occasional win but continued overall loss of capital. This was not taking on more risk for a higher expected return, this was "having a punt", or buying lotto tickets in the hope that there would be an immediate and significant payoff. In our view this is unlikely to be a successful strategy for the majority of market participants.

But what is the harm?

Our view is that risk-seeking behaviour is dangerous for any person. In some ways we consider the risk of speculating to be far greater in many ways for the younger person than it is for the older person. Someone who is close to retirement risks not being able to spend the money that is being speculated in the near term. This is a very great risk, particularly if the funds are required to pay for living expenses. But the cost to the young man or woman from permanent loss of their early savings is the huge opportunity cost of having not invested wisely. This opportunity cost is rarely measured but should be considered as the risk of having a punt where the punt involves a substantial and, we would suggest even likely, risk of permanent loss of capital.

For example, a fully employed person in their mid-thirties with $100,000 in accumulated savings today may expect to invest those savings, with no immediate need to spend the capital, for the next thirty year period. If this person invests in cash-like products history suggests that they may earn in the order of 5% per annum. In 30 years time the $100,000 will be worth just over $432,000. Assuming 2.5% inflation per annum this is the equivalent spending power of over $206,000 in today's dollars. This growth in capital is perhaps not significant enough to convince this investor to change their behaviour.

Nominal return $100,000 compounded at different rates & time periods			
Time	5%	10%	15%
10 Yr Return	$162,889	$259,374	$404,556
20 Yr Return	$265,330	$672,750	$1,636,654
30 Yr Return	$432,194	$1,744,940	$6,621,177
40 Yr Return	$703,999	$4,525,926	$26,786,355

Real return $100,000 compounded & adjusted for inflation			
Time	5%	10%	15%
10 Yr Return	$127,249	$202,623	$316,038
20 Yr Return	$161,923	$410,560	$998,802
30 Yr Return	$206,045	$831,887	$3,156,598
40 Yr Return	$262,191	$1,685,593	$9,976,059

However, consider the following. If instead the person invests the money in an equity market index, history suggests that closer to 10% per annum *may* be possible over the long run.

If a 10% per annum return is achieved, after 30 years the $100,000 would be worth approximately $1.745m or close to $832,000 in today's dollars. For long-term financial security the maths is starting to add up as to the significance of where this capital is invested today for future prosperity. Occasionally there will be a manager with a long track record of consistently outperforming the stockmarket indices by circa 5% per annum. If you are fortunate enough to find and invest with such a manager, stick with them! If that manager were to achieve 15% per annum net return to investors, in 30 years the $100,000 would be worth around $6.6m, or over $3.1m in today's dollars!

Obviously this simple analysis involves making a few general assumptions that could prove materially different from reality, such as the assumption that no taxes are required to be paid during the investment period. For those market participants who invest through their self-managed superannuation fund, this is probably not too poor an assumption, especially given dividend imputation. But the point of the exercise is to recognise the power of compounding. Perhaps telling the broker in the story that his punting today will cost him $6.6m in 30 years will change his thoughts on the cost of these speculations? The risk is in the opportunity cost of investing this money *wisely* for the foreseeable future. In dollar terms, his risk is far greater than the person already in retirement.

We would suggest that a manager who outperforms the index by 5% per annum is not risk-seeking but actually focused on maximising expected return in the context of taking risk. Often such a manager may actually be relatively risk intolerant. They look for situations which might earn them 10-15% per annum with very low risk.

While only hindsight can determine the success or otherwise of any strategy, we try to find investments with attractive prospective returns for the level of risk we are assuming. We are more concerned with potential loss of capital than potential return. Any equity manager accepts that they take risk, the question is whether this risk is acceptable for the expected outcome, which must include some measure of variance of expected return. At Auscap we are focused on finding good businesses that generate strong cash flows for their shareholders at attractive prices. Our long term success will be dependent on our ability to find such investments. We think it's the best way of operating, and that's why, as Auscap's portfolio managers, we have no external ñPAòpositions. Our only Australian equities exposure is through the Auscap Long Short Australian Equities Fund.

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 wholesale investors can download a copy of the Auscap Long Short Australian Equities Fund Information Memorandum at www.auscapam.com/information-memorandum. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.