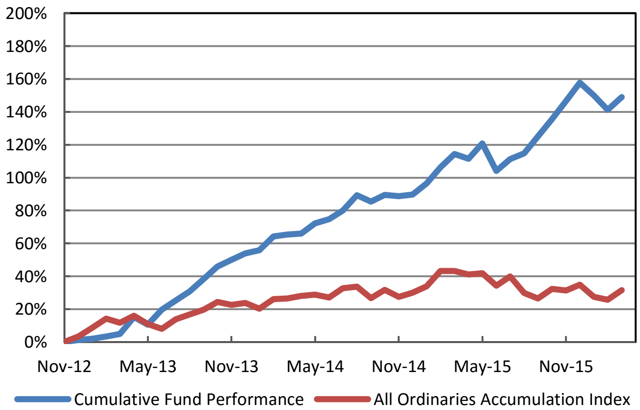
Auscap Long Short Australian Equities Fund Newsletter – April 2016

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 debate around whether companies are foregoing investment opportunities in order to pay higher dividends.

Fund Performance

The Fund returned 3.22% net of fees during March 2016. This compares with the All Ordinaries Accumulation Index return of 4.74%. Average gross capital employed by the Fund was 54.3% long and 5.5% short. Average net exposure over the month was 48.8%. At the end of the month the Fund had 17 long positions and 3 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, consumer staples, healthcare and energy sectors.



Fund Returns

Period	Auscap	All Ords
March 2016	3.22%	4.74%
Financial Year to date	21.94%	[1.95%]
Calendar Year to date	[3.43%]	[2.35%]
Since inception	148.98%	31.67%

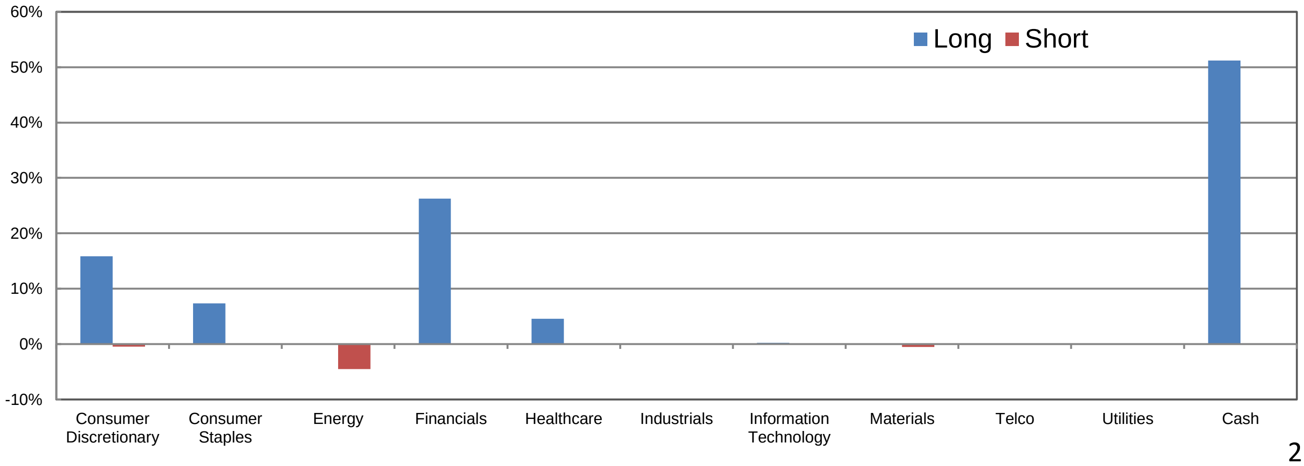
Fund Exposure

March 2016 Average	% NAV	Positions
Gross Long	54.3%	19
Gross Short	5.5%	3
Gross Total	59.8%	22
Net / Beta Adjusted Net	48.8%	34.4%

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	4.90	3.98	(1.36)	4.43	(7.55)	16.81
FY16	3.46	1.64	4.82	4.65	4.69	4.56	(3.01)	(3.54)	3.22				21.94

Sector Exposure - March 2016

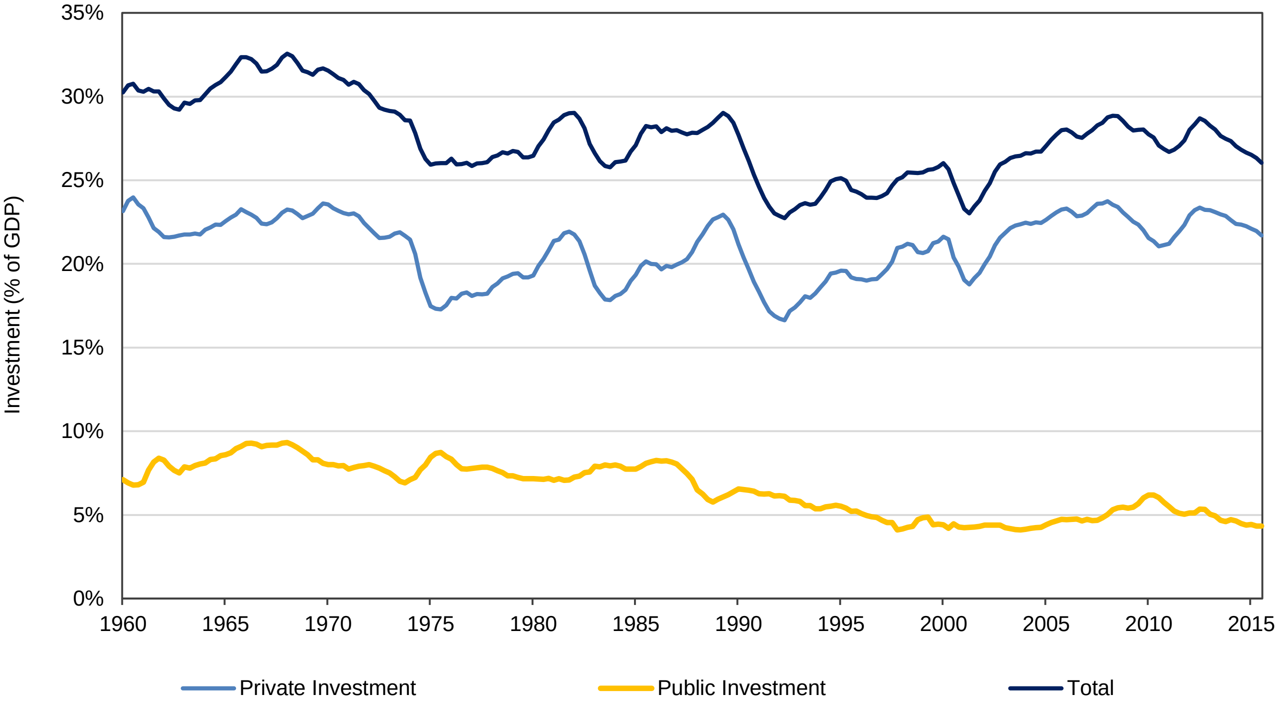


The great debate: dividends vs investment

In the boardrooms of corporate Australia and across the national press there has been a great debate unfolding. The suggestion is that payout ratios, or the amount of corporate income that is paid to shareholders in the form of dividends, are too high nationally. Apparently many companies are sacrificing future growth opportunities to satisfy the current income demands of their shareholders. There are actually two issues here. Payout ratios are too high if they are unsustainable in the context of existing capital requirements, operational cash flow, business growth and/or investment opportunities. If good investment opportunities are being foregone for the sake of paying dividends, this might be one reason that dividends are too high. But they might also be too high because business fundamentals are deteriorating, or working capital requirements are increasing, or regulatory standards are requiring balance sheets to be less leveraged. In this newsletter our discussion centres on whether companies are foregoing investment opportunities to satisfy the income demands of shareholders.

So is a focus on dividends coming at the expense of investment? The national accounts indicate that aggregate investment, while off its highs, is certainly not materially below the average of the last few decades when measured as a percentage of Gross Domestic Product (GDP). Private investment is not languishing at historic lows, despite the fact that investment in mining and energy projects is on the decline.

Private and Public Investment in Australia



Source: Auscap, Australian Bureau of Statistics

This does not surprise us. Anecdotally, we have not had many discussions with company management teams who are delaying investment decisions because of the perceived need to pay dividends. Most companies with sensible opportunities to grow their businesses organically are taking those opportunities and expanding aggressively. Capital markets are currently very favourable for businesses with natural growth options, attributing a significant premium to such companies. The demand from investors for companies with growth has led to the highest market valuation dispersion on a Price to Earnings (P/E) basis in nearly a decade. Companies with growth are being rewarded, not penalised. Management teams are being incentivised to pursue expansionary options if they are available, with investors placing a significant valuation premium on those companies that promise growth.

The ongoing debate begs the question, are we talking about a lack of willingness to invest or a lack of sensible investment opportunities? Given that we see very little of the former, we suggest the debate is actually about the latter in disguise. The Australian stockmarket is characterised by the dominance of a small number of very large and oligopolistic institutions. The major banks, supermarket chains, telecommunication providers and insurers are very dominant domestic businesses, in many instances with market share that is simply unable to grow substantially from such high current levels. Large established companies in traditional sectors do well to generate revenue growth a few percentage points above GDP growth, a very respectable outcome and one that we think should be applauded. To achieve such an outcome involves running the business particularly well against seasoned and knowledgeable competitors, taking incremental market share from other participants where possible and making sensible and typically small (relative to the size of the organisation) organic investments. Should we be encouraging these companies to overreach and pursue ambitions of growth that, in the context of their markets, are unrealistic? The outcome of such pressure typically involves venturing aggressively into new markets with a “big bang” solution. But is this best for long-term shareholder wealth generation?

We differentiate between what we see as stereotypically good and bad investment decisions. Good investment decisions typically involve incremental organic investment. There is no sudden strategy announcement or immediate earnings per share uplift. Rather, there is sensible and sustained capital expenditure focused on improving and expanding the business operation on a continuous basis. In our dealings with corporate management, we get most enthused when we see executives, particularly those in mature businesses, focusing on the little things. Whether it is working hard at optimising their operations, focusing on improving productivity, acting to take incremental market share and protect against inevitable competition or investing as though they were investing their own capital. In other words, investing with discipline, prudence and patience.

We are entirely supportive of management investing to generate growth if the investment is based on sensible financial analysis that demonstrates an attractive and appropriate risk-adjusted total return on capital. Sometimes incremental investment takes time to yield results. There is no immediate accretion to earnings, just a sound strategy to build a presence in a new market that has compelling long term fundamentals or improve margins a percentage point or two over time. We are patient investors and will continue to encourage the companies that we own stakes in to make sensible investments of this nature. We would encourage the CEOs of these businesses to invest in them as though they personally own them and will do so for the next fifty years.

Poor investment decisions are often the result of risk-seeking behaviour. Risk-seeking behaviour involves taking risks with shareholders’ capital to make poor prospective risk-adjusted returns over the long run. Such behaviour might be driven by any number of things, but an extreme focus on near term earnings growth would need to be near the top of the list. Corporate leaders cannot make something from nothing. A cyclical business will have periods of declining revenues and earnings. Such a business should not be encouraged to try to “iron-out” the cyclicality because it focuses attention on the wrong thing. Long term wealth generation, not improving next period’s Earnings Per Share (EPS), is the aim of the game. If there are no sensible and compelling investment opportunities then we would not encourage pursuing pass-the-parcel strategies of acquisitions and divestments in the name of financially engineering the next year’s reported earnings. Such strategies are very good for bankers, lawyers, accountants and the Australian Taxation Office, but they are not good for investors.

Acquisitions in unrelated fields or in foreign domiciles need to be considered very carefully before they are pursued. There are good operators in most sectors in most markets. So if, as a “foreign” entrant (because of little prior knowledge in the sector or market), you win the right to take over a company that both the existing shareholders are happy to part with and local competitors are happy to avoid at the price you are paying, then we suggest there needs to be a strong rebuttal to the assumption that you are paying too much! Winning an auction often means you have paid above every other knowledgeable buyer’s estimate of fair value. History is not exactly replete with success stories from those who bet the farm guessing that they could run someone else’s business more effectively.

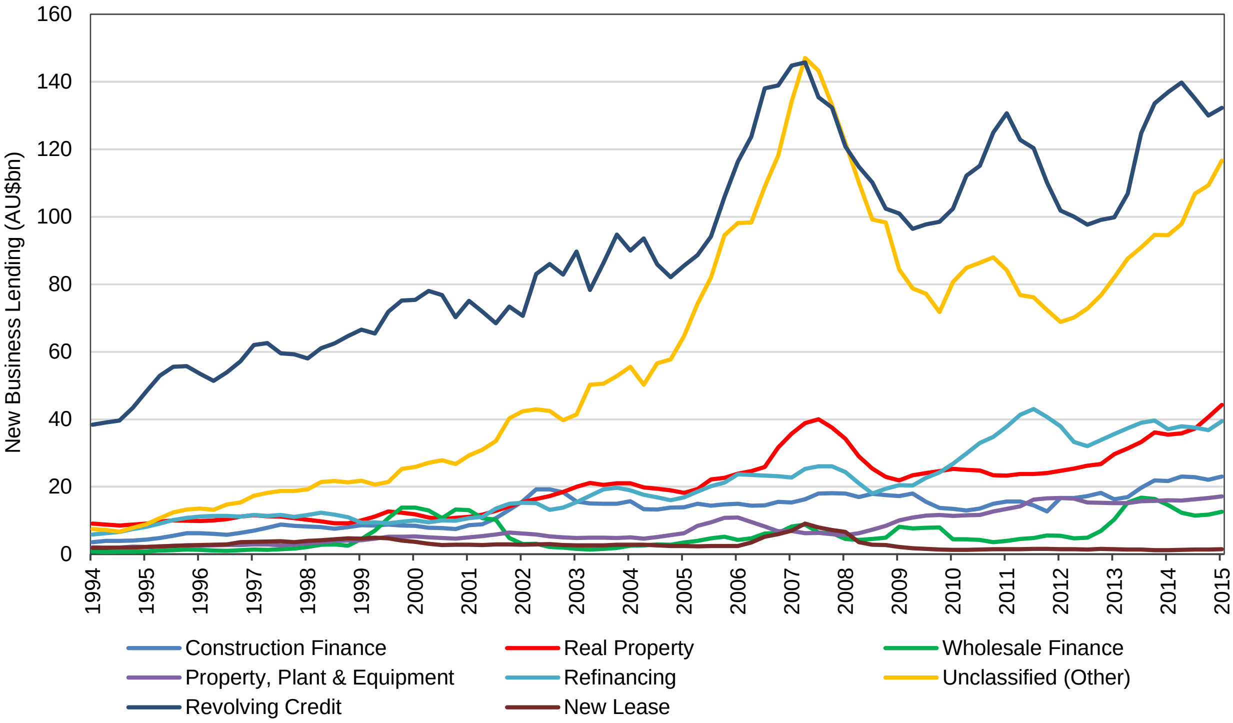
Near term earnings growth, in our view, should not be the entire managerial focus. We are surprised by investor encouragement of transactions which trade strong, sustainable, high barrier to entry, low growth businesses for higher short term prospective growth opportunities in industries that have few barriers to entry and no clear long term sustainable competitive advantage. Such a strategy might look sensible on a one or two year view, but we are doubtful as to whether it looks particularly compelling if you think about which assets you want to own forever.

We are wary of commentators publicly and privately encouraging behaviour centred on near term earnings growth and business expansion. There are already considerable forces at work encouraging poor capital allocation. Corporate CEOs can be conflicted because they are typically not long term owners of the business. Their incentive structures are normally short term oriented with a focus on next year's EPS. Immediately accretive acquisitions are tempting whether or not the acquisitions are likely to be value-adding long term. CEOs can be enticed by "company-transforming" acquisitions because they share in the upside if things turn out favourably and little of the downside if this is not the case. They have a plethora of financial professionals encouraging them to pursue risk-seeking behaviour and justifying takeover premiums because of the fees involved. It reminds us of the adage, don't ask the barber if you need a haircut. Self-interest is a powerful force.

From many accounts there certainly appears to be pressure on CEOs to achieve constant revenue and earnings growth even if it is unrealistic to expect as much. For the large domestic companies that have successfully come to dominate their respective industries there is little near term opportunity for them to be growing at rates substantially exceeding the growth in national GDP. Perhaps encouraging business optimisation is the most sensible course.

By contrast, it appears that small and medium sized businesses are actually continuing to invest. If new bank lending to business data is an indication of new capital expenditure, recent numbers suggests positive trends for many forms of investment. Some of these businesses will be the leaders of the future, but their development will take time.

Australian Business New Bank Lending - Credit Approval by Purpose



Source: Auscap, APRA

So long as Australian policy encourages domestic investment there will be entrepreneurs trying to build for the future, of that we have little doubt. But Australia is a cyclical economy, due to its very beneficial exposure to natural resources, especially in the context of the size of the domestic population. So private investment will likely occur in waves in line with the business cycle. Trying to expedite the next private investment phase is likely to lead only to poor investment decisions and impaired capital. In our view, the Government is best placed to act as the counterbalance to the cyclicality of the private investment landscape. A boost to public investment in domestic infrastructure would appear to be the most sensible offset to the decline in resource investment. With the cost of Government debt at record lows, economic returns from sensible infrastructure projects should comfortably exceed the cost of capital. There should be no shortage of superannuation trustees lining up to provide the funds were it required. Perhaps this should be the focus of the debate given public investment is sitting at close to multi-decade lows.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website http://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.

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