



## **Auscap Long Short Australian Equities Fund Newsletter – April 2017**

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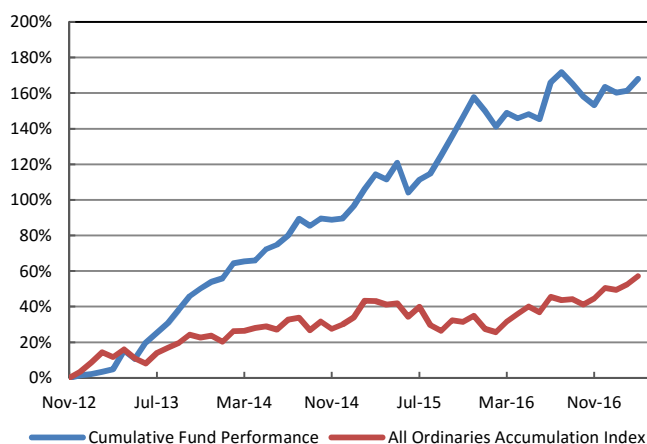
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**Welcome**

Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (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 discuss how compounding returns are affected by positive and negative performance.

**Fund Performance**

The Fund returned 2.52% net of fees during March 2017. This compares with the All Ordinaries Accumulation Index return of 3.16%. Average gross capital employed by the Fund was 111.7% long and 25.6% short. Average net exposure over the month was 86.1%. At the end of the month the Fund had 33 long positions and 11 short positions. The Fund’s biggest stock exposures at month end were spread across the real estate, financials, consumer discretionary and telecommunications sectors.



**Fund Returns**

Period	Auscap	All Ords
March 2017	2.52%	3.16%
Financial Year to date	9.25%	14.84%
Calendar Year to date	1.72%	4.43%
Since inception	167.98%	57.26%

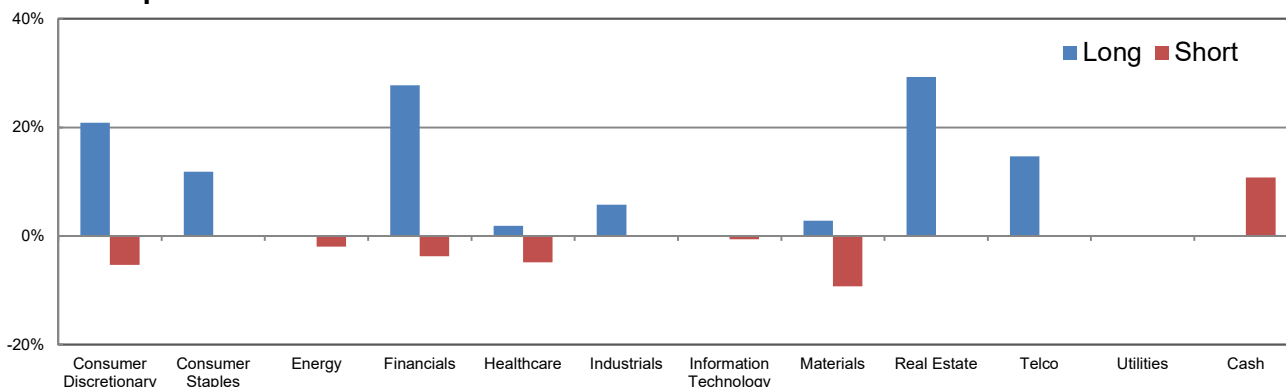
**Fund Exposure**

March 2017 Average	% NAV	Positions
Gross Long	111.7%	34
Gross Short	25.6%	11
Gross Total	137.3%	45
Net / Beta Adjusted Net	86.1%	43.6%

**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	(1.24)	0.96	(1.19)	20.13
FY17	8.48	2.13	(2.37)	(2.72)	(1.83)	4.00	(1.20)	0.42	2.52				9.25

**Sector Exposure - March 2017**



## Compounding Capital Considerations

As an asset manager, our primary objectives are to preserve our investors’ capital and generate a return on that capital over time. We constantly remind ourselves that if the two objectives appear to be in conflict with one another, then the former should always take precedence. Attempting to achieve returns should not override the necessity of protecting the capital base. As a value-focused manager we are looking to buy stocks that we consider to be cheap relative to the prospective cash earnings and quality of the business. We try to buy high quality companies at what we believe to be attractive prices.

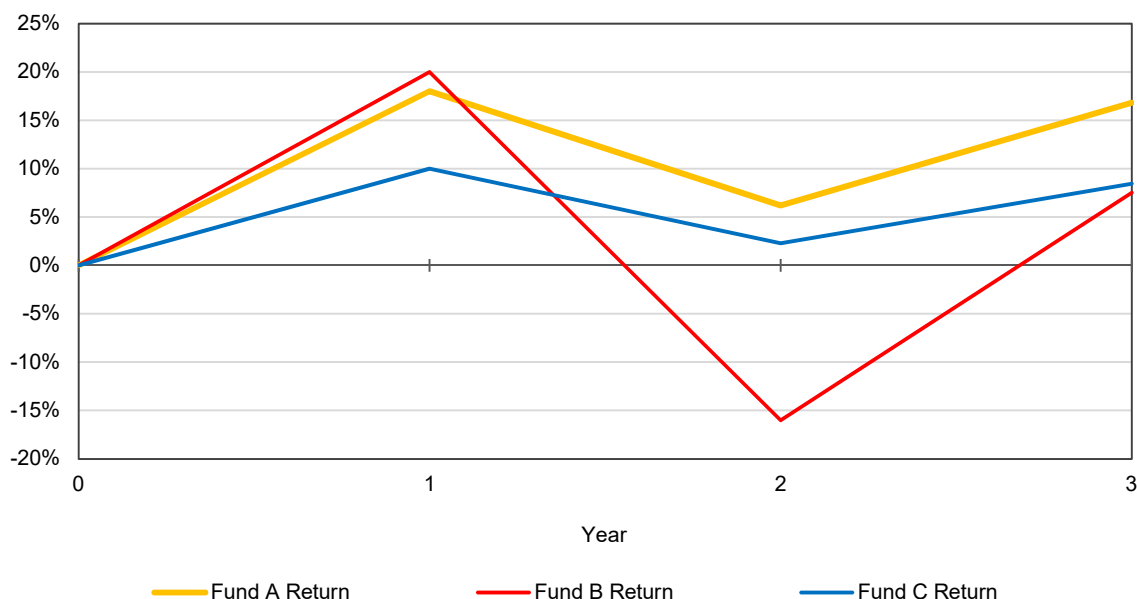
Why are we selective on price? The objective is to limit the downside within the portfolio. As a value-driven long short fund we aim to outperform in sideways and declining markets. Our view is that in doing so, long term outperformance can be achieved. Conversely, we would expect to underperform a strongly rising market. In such circumstances, value-based investments typically lag the broader market. Additionally, the shorts tend to detract from performance because, in the words of John F Kennedy, “a rising tide lifts all boats”.

It is important to note that because of the compounding (or geometric) nature of investment returns, negative returns have a disproportionate effect on aggregate performance. To use an example, assume three funds have the following return profiles over three consecutive years:

Year	Fund A	Fund B	Fund C
Year 1 Return	+18%	+20%	+10%
Year 2 Return	-10%	-30%	-7%
Year 3 Return	+10%	+28%	+6%
<b>Simple Average Return</b>	<b>+6%</b>	<b>+6%</b>	<b>+3%</b>

Which fund would you rather be invested in? Fund A and Fund B have the same simple (or arithmetic) average return of 6% across the three years, while Fund C’s simple average return is only 3%. Funds A and C lag in the good years, but have a significantly better year relative to Fund B in year 2, when all three funds experience a negative year. However, a focus on simple averages misrepresents the outcome for an investor. This is where compound (or geometric) returns come into play. The fact that returns compound each year strongly favours minimising the size of the negative returns. The compound returns of the different funds are illustrated in the chart below and demonstrate the actual cumulative return to the investor at the end of each year.

**Cumulative Returns for Funds A, B & C**



Actually, after the three years, Fund A has delivered the highest total return of 16.8% to its investors. Fund C has been the second best performer, with an 8.4% total return, despite having half the simple average return of Fund A and Fund B. Fund B has delivered only 7.5% total return to its investors, despite having the largest two positive return years, because of the size of the negative return in year 2. Compounding (or geometric) returns are strongly affected by how managers perform in negative years for the market. This is why we focus on value investing, on paying an attractive price for our investments, which, along with the Fund’s capacity to short sell, aims to reduce the downside in the portfolio. We will, of course, have negative periods of performance, however we would be disappointed if we did not outperform in the majority of the years in which the market declines.

	Fund A	Fund B	Fund C
Simple Average Annual Return	+6.0%	+6.0%	+3.0%
<b>Average Compound Annual Return</b>	<b>+5.3%</b>	<b>+2.4%</b>	<b>+2.7%</b>

The Auscap Fund’s returns since inception have exceeded our expectations as managers. Interestingly, the outperformance of the Fund to date has, on average, come from periods of weak market performance. As the table below demonstrates, Auscap’s outperformance relative to the All Ordinaries Accumulation Index (Index) can be explained by the Fund’s performance during periods when the broader market has been declining. On average when the market has risen during the month, the Fund has lagged the Index, delivering an average positive return of +3.0% against +3.2% for the Index. By contrast, when the market has declined during the month, the Fund has *on average* outperformed, returning an average positive performance of +0.3% against a market decline of –2.7%. **We will certainly not always outperform in declining markets, but we do strive to outperform on average in these periods.**

**Auscap Fund Performance Analysis**

	Auscap Fund	All Ordinaries Accumulation Index
Average return in positive months for the Index	+3.03%	+3.21%
Average return in negative months for the Index	+0.28%	[–2.70%]
<b>Average Compound Annual Return Since Inception</b>	<b>+25.5%</b>	<b>+11.0%</b>

We should note that we do not wish to dwell on monthly data, as it is definitely too short a time frame over which to assess portfolio management. That said, the data does demonstrate an important fact, that if you preserve capital when markets are poor then compounding returns will look after themselves. We would not expect this unusually strong outperformance in weak markets to continue over time. However, our annual objectives will continue to be to target outperformance in weak markets, with an expected lag in strongly rising markets.

How can one identify when markets will be strong or weak? We have no great insights, nor do we spend any time forecasting the direction of markets, be it the stockmarket or any other, and we know of no reliable way to predict their direction. Our investment focus is on remaining consistent in our process, staying disciplined with our risk management and improving both of these aspects of portfolio management over time so that we can, hopefully, reduce the number and impact of the errors we make. Discipline in purchasing decisions, meaning only paying what we consider to be attractive prices for our investments, is a key aspect of how we aim to reduce the downside risk associated with equity market investments.

***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 investors can download a copy of the PDS at [www.auscapam.com/auscap-fund/pds](http://www.auscapam.com/auscap-fund/pds). We welcome any feedback, comments or enquiries. Please direct them to [info@auscapam.com](mailto:info@auscapam.com).

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