Auscap Long Short Australian Equities Fund Newsletter – August 2017

The Auscap Long Short Australian Equities Fund has been rated "Recommended" by Zenith and Lonsec. Interested wholesale and professional investors can download a copy of each report from the Auscap website www.auscapam.com.

Please note that the Auscap Fund's administrator, White Outsourcing Pty Ltd, has been acquired by Link Administration Holdings Limited and is now known as Link Fund Solutions.

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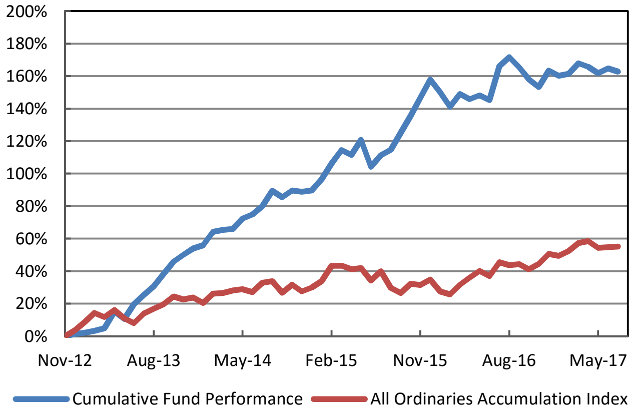
Welcome

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 opportunities that can be taken advantage of by having a longer investment time horizon than the typical market participant.

Fund Performance

The Fund returned negative 0.77% net of fees during July 2017. This compares with the All Ordinaries Accumulation Index return of 0.18%. Average gross capital employed by the Fund was 102.5% long and 12.1% short. Average net exposure over the month was 90.4%. Over the month the Fund had on average 28 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, financials and consumer discretionary sectors.



Fund Returns

Period	Auscap	All Ords
July 2017	[0.77%]	0.18%
Financial Year to date	[0.77%]	0.18%
Calendar Year to date	[0.24%]	3.00%
Since inception	162.81%	55.11%

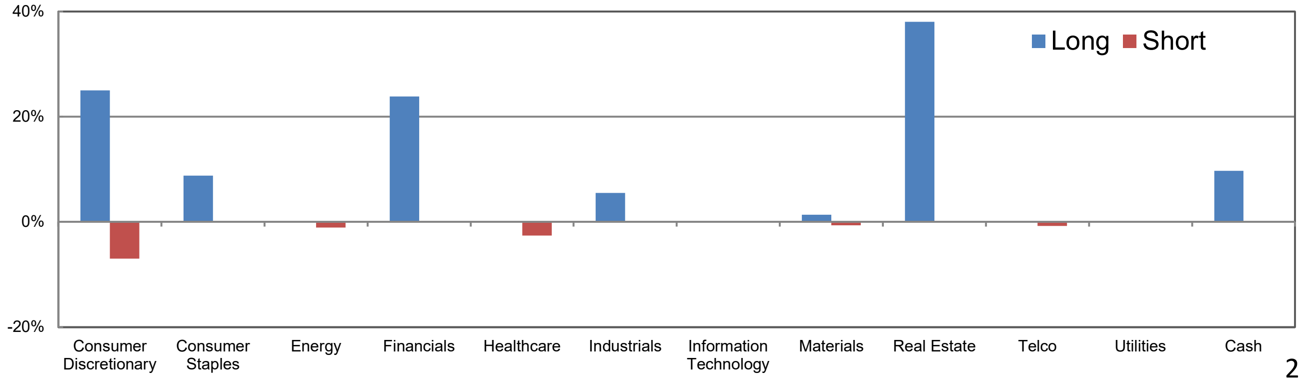
Fund Exposure

July 2017 Average	% NAV	Positions
Gross Long	102.5%	28
Gross Short	12.1%	7
Gross Total	114.6%	35
Net / Beta Adjusted Net	90.4%	51.4%

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	(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	(0.81)	(1.53)	1.18	7.97
FY18	(0.77)												(0.77)

Sector Exposure - July 2017

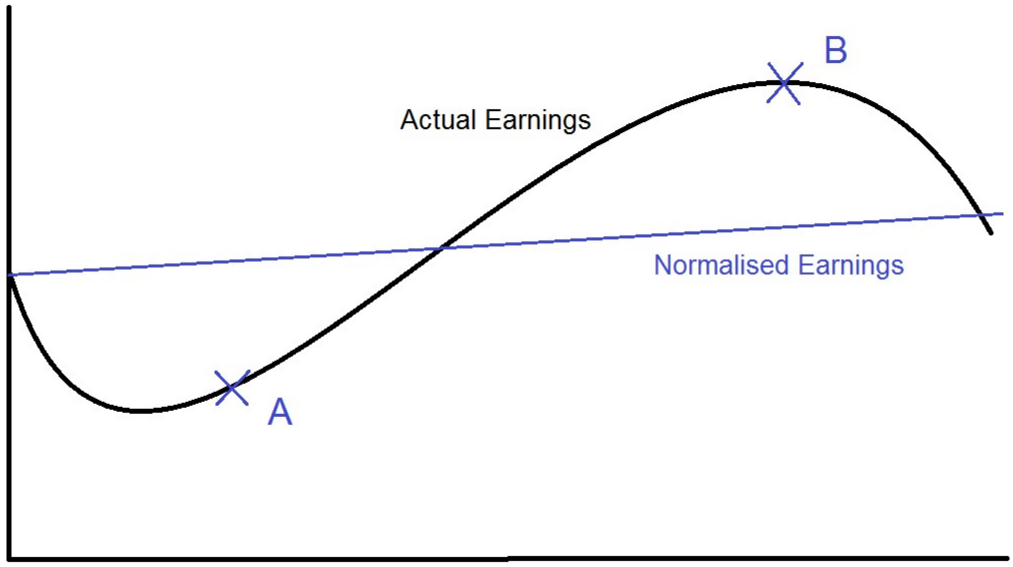


Taking advantage of time horizon arbitrage

As we enter the full year reporting season, short term results dominate the newspaper headlines and dictate the short term direction of the share prices of the reporting companies. We suspect as a result of this they dominate most investors' thinking and actions. We are hopeful that this reporting season will be typical in providing at least one or two investment opportunities. Most of the time such opportunities come from what we would classify as time horizon arbitrage, historically a reasonable source of alpha for the portfolio.

Time horizon arbitrage is taking advantage of the short duration of most investors' thinking by instead focusing on what should be expected from the business over the medium term. As many value investors would attest, focusing on through-the-cycle earnings to buy stocks when they appear cheap against 'normalised' earnings and selling those same stocks when they appear expensive against the same metric at some point in the future can be an extremely profitable exercise. On a short term earnings basis the company may well be struggling, with depressed margins, slower sector growth and near-term business headwinds (point A below). This is particularly the case with many cyclical sectors. Due to slower near term growth, such stocks will often trade on depressed multiples of their current earnings. These current earnings are well below 'average' earnings for the business, as can be ascertained from a simple analysis of their past accounts.

But as time passes, some of the struggling businesses in the sector might close or cut capacity, reducing competition and supply. Business conditions may improve resulting in an increase in demand. As this occurs profitability returns to typical levels. The company now becomes a growth stock for many investors, who accumulate a position as the company's performance normalises. As growth accelerates to the peak, the stock becomes a crowd favourite. Investors pile in just as earnings growth looks greatest and margins are close to peak levels. At this point the business is typically making a lot of money (point B). The profitability attracts new competitors who start competing for business, short term demand often peaks around the same time and so begins the cyclical downswing. This process is represented by the chart below.



Analysis of historical data often invites sensible forecasts that are more about the medium than the short term, where marginal changes to growth are difficult to forecast for investors external to the company. This is particularly the case for forecasting medium term growth in businesses with proven products, natural competitive advantages, steadily growing demand and key revenue drivers that are largely macroeconomic, such as the rates of population growth and inflation for consumer facing businesses, as we have discussed in past newsletters. In these instances focusing on time horizon arbitrage can provide us with terrific opportunities.

Not only are we buying stocks when they are cheap against anticipated through-the-cycle margins, but stocks facing near term headwinds frequently trade at lower multiples of earnings. After all, lower growth companies are generally seen as less exciting investment opportunities than businesses with stronger near term growth. This combination can present attractive purchase prices. The converse is also true. When market conditions peak for a business the growth is typically strongest and such companies often trade at lofty multiples due to their strong historic and/or near term growth profiles. It is a double win for the value investor to buy into such companies when growth is lowest and valuations are cheap, and then sell when growth in peaking and valuations are based on elevated earnings. Not only is there the uplift in valuation from margins and earnings reverting to normal levels, but the market pays more for those earnings than it was willing to pay when growth was lower.

Naturally there are reasons to be cautious about such an approach. The "value trap" is a common mistake encountered by value investors. A company may appear cheap based on past performance, enticing the investor to purchase stock, only for the investor to suffer as earnings continue to decline and the stock price follows suit. Structural change in an industry is often a cause of such circumstances, if the structural change has resulted in newer business models taking away the profitability of the older business models. In these instances the decline in margins and profitability is not cyclical, it is structural and frequently permanent. We try to be aware of the value trap and focus on businesses where we can be confident that over the medium term there will be continued growth in revenues and profits for shareholders. Focusing on businesses where there is a great likelihood of significantly higher revenues in five years time can be a good antidote to falling into the value trap. We will continue to turn over new rocks and re-acquaint ourselves with old ones this reporting season in the hope that we can take advantage of the opportunity time horizon arbitrage provides to astute investors.

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