Auscap Long Short Australian Equities Fund Newsletter – December 2016

The Auscap Long Short Australian Equities Fund is now registered (ARSN 615 542 213) and is open to retail and platform investors. Interested investors can download a copy of the Product Disclosure Statement (PDS) from the Auscap website www.auscapam.com. If you wish to invest via a platform or an Investor Directed Portfolio Service (IDPS), please contact your financial adviser or platform operator.

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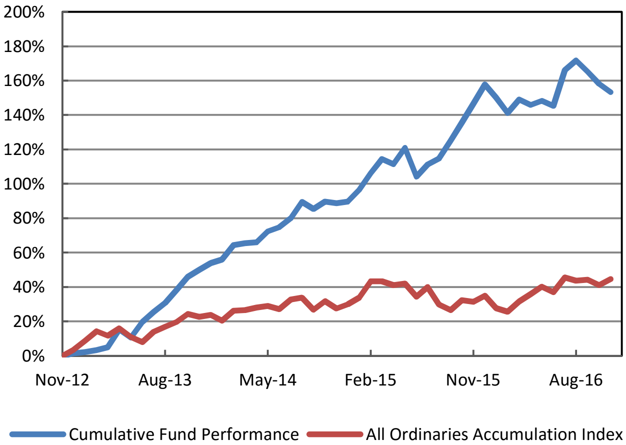
Welcome

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 the irony of risk and how it creates opportunities for the value investor.

Fund Performance

The Fund returned negative 1.84% net of fees during November 2016. This compares with the All Ordinaries Accumulation Index return of 2.46%. Average gross capital employed by the Fund was 141.9% long and 11.0% short. Average net exposure over the month was 130.9%. At the end of the month the Fund had 38 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, financials, telecommunications and consumer discretionary sectors.



Fund Returns

Period	Auscap	All Ords
November 2016	[1.84%]	2.46%
Financial Year to date	3.27%	5.57%
Calendar Year to date	[1.74%]	7.21%
Since inception	153.33%	44.56%

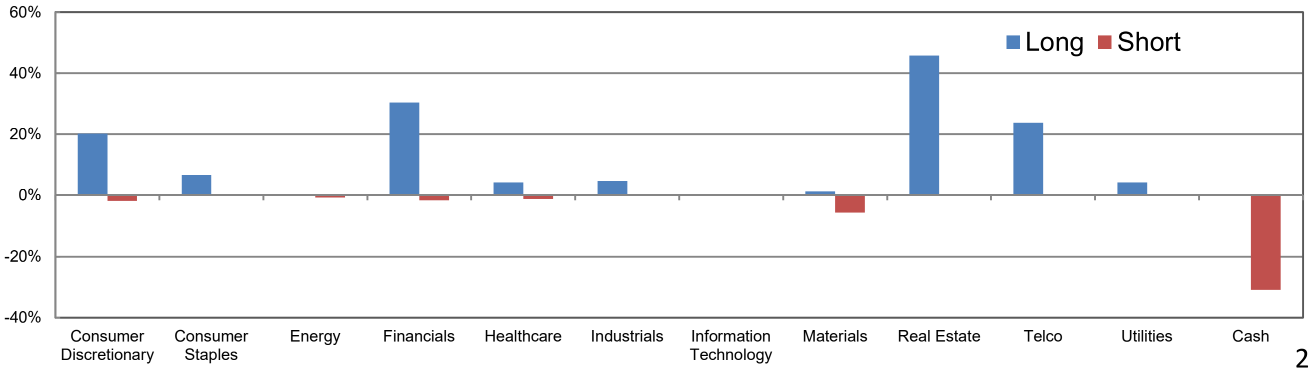
Fund Exposure

November 2016 Average	% NAV	Positions
Gross Long	141.9%	37
Gross Short	11.0%	7
Gross Total	152.9%	44
Net / Beta Adjusted Net	130.9%	86.6%

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)	(1.84)								3.27

Sector Exposure - November 2016



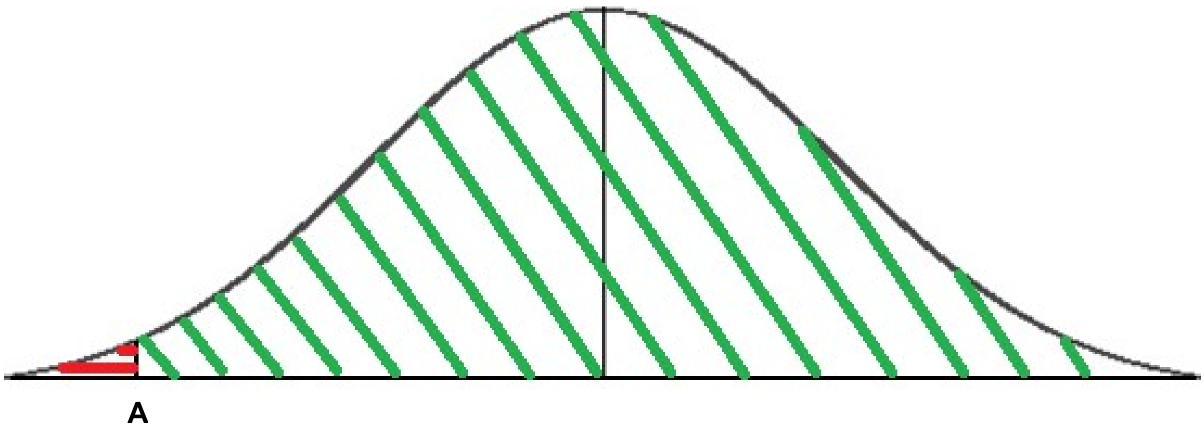
Part 3: The irony of risk

The irony of risk is that when a risk is most obvious, most discussed and most feared, assets are normally being priced attractively to compensate for that risk. When risk is present but not feared, not apparent or not acknowledged, asset prices typically rise, which can lead to investors receiving inadequate compensation for the risks that they are taking. Risks that have not appeared for a long time are often assumed not to exist. But investment risks are always present whether or not we choose to pay attention to them and irrespective of whether or not they cause loss. In the January newsletter we will bravely attempt to discuss this point in the context of Australian residential property values, stay tuned!

In assessing risk, it is very easy to confuse actual results with the probability that those results were going to be achieved. This is misinterpreting what actually occurred with the likelihood that it might have occurred compared with any other potential outcome. Similarly it is a mistake to assume that the probability of an event is low just because it has not occurred or has occurred very rarely. The latter may be an indicator of the former, but it may also be that recent circumstances have been anomalous for the lack of occurrences of negative events affecting a particular business. If risks are assumed to be low then they get priced accordingly, irrespective of the actual level of risk. This is when risk can become most damaging. It is also typically when leverage is encouraged and valuations become stretched, a dangerous combination with potentially severe consequences, as many listed companies found out during the Global Financial Crisis.

Ironically, if a specific risk is discussed regularly it is most likely going to be priced appropriately. Risks are far more dangerous when they are hidden than when highlighted because of the lack of consideration of them in the pricing of a security, a sector or the stockmarket as a whole. Occasionally, certain risks are highlighted so frequently that investors can almost be confident that the prospective return compensates for the risks involved. There are frequent examples of this, where a stock, a sector or even the entire market falls leading into an event that is seen as negative. It becomes a focal point for the mainstream media, only for the risk to actually eventuate, and despite this the stock, the sector or the market then proceeds to rally almost immediately. We have seen this recently with both the Brexit and Donald Trump's election as President of the United States of America.

We focus on opportunities where risk is being actively considered and priced attractively. Occasionally events like those discussed above occur and have a large impact on investor psychology. Suddenly risk becomes very apparent, and companies exposed to potential risk, whether or not it has actually negatively impacted company earnings, become priced assuming that a near worst case scenario will eventuate. This is where we believe rational decision making is most important. If the price of an investment suddenly reflects a negative tail risk outcome (represented as A below), despite this outcome remaining a low probability possibility, it is highly probable that purchasing assets at this price will prove profitable over time.



To use a specific example, Australian listed fund managers with UK exposure were sold heavily following the Brexit. Many analysts assumed very negative circumstances would result, including:

- a significant decline in the British pound;
- strong equity market outflows;
- a significantly lower stockmarket; and
- no ongoing performance fees.

The market began to price exposed securities assuming these outcomes, despite the fact that the likelihood of all four occurring remained low. Very quickly it became apparent that these assumptions would prove incorrect. This afforded investors an attractive entry point into a few high quality businesses that had been sold off heavily on the fear that these outcomes would eventuate.

We focus on evaluating the probability of an event separately to evaluating the consequence of the event. Sometimes opportunities present themselves where an apparent risk eventuates and certain companies are sold off heavily despite the tenuous link as to why the particular event would affect these companies. Broadly speaking, the impact of foreign macroeconomic events on the cash earnings of Australian listed companies is often likely to be quite small. If stocks sell off on such issues it can represent an opportunity for the value investor. Conversely, we prefer not to invest in businesses that have known company specific risk which, while having a low probability of occurring, would result in significant permanent capital loss. We are acutely aware of the impact that a large negative return can have in a series of compounding numbers. From our perspective this is unacceptable risk.

At Auscap, we focus on risk being the defining feature of our investment process, rather than a necessary task done after the investment decisions have been made. We are constantly focused on opportunities in sectors of the market where we think the risks are being priced appropriately and we will seek to avoid the cyclical stampede toward stocks that are being priced for perpetually positive news. While accepting that we will make mistakes, we think this approach is the best way to generate long term compounding returns.

As mentioned at the start of this newsletter, the Fund is now open to retail investors. If you would like a copy of the Product Disclosure Statement, it is available at www.auscapam.com or please contact us on (02) 8378 0800. If you would like to invest through a platform please contact your adviser, platform or IDPS operator.

We would like to take this opportunity to thank our investors for their support. We wish all of our readers a safe and happy festive season and all the very best for 2017!

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