Auscap Long Short Australian Equities Fund Newsletter – February 2016

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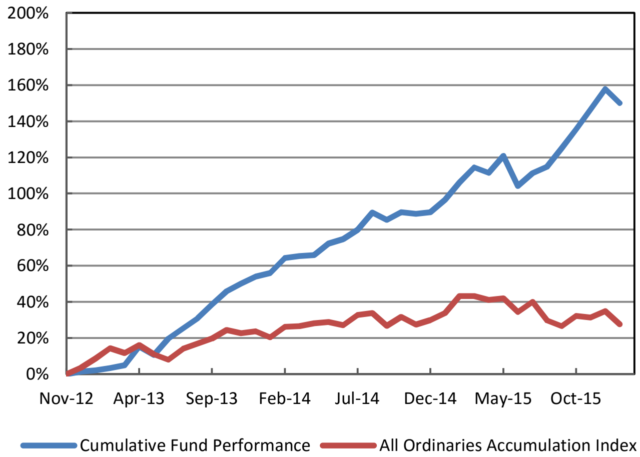
Welcome

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 from a broad perspective whether the market's decline has presented value-based investors with a buying opportunity or simply reflects deteriorating economic fundamentals.

Fund Performance

The Fund returned negative 3.01% net of fees during January 2016. This compares with the All Ordinaries Accumulation Index return of negative 5.38%. Average gross capital employed by the Fund was 79.2% long and 30.3% short. Average net exposure over the month was 48.9%. At the end of the month the Fund had 23 long positions and 18 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, consumer staples, healthcare, energy and materials sectors.



Fund Returns

Period	Auscap	All Ords
January 2016	[3.01%]	[5.38%]
Financial Year to date	22.47%	[4.99%]
Calendar Year to date	[3.01%]	[5.38%]
Since inception	150.06%	27.58%

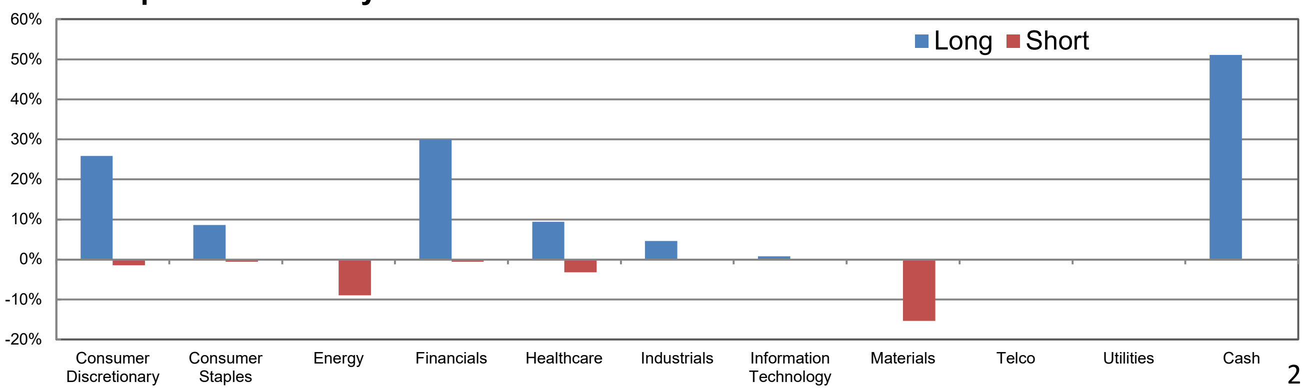
Fund Exposure

January 2016 Average	% NAV	Positions
Gross Long	79.2%	26
Gross Short	30.3%	15
Gross Total	109.5%	41
Net / Beta Adjusted Net	48.9%	12.0%

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)						22.47

Sector Exposure - January 2016



Is Now The Time To Buy?

2016 has started with significant volatility in global equity markets. The Australian market has not been spared, with the ASX200 Index falling 5.48% in January and continuing this declines into early February. In the 11 months ending 31 January 2016, the index was down 15.6% from its monthly closing high of 5929 in February 2015. The question is, have these declines presented an opportunity for value-based investors? We would caution against making this conclusion too hastily.

In our view opportunity is created when investors overreact to changing circumstances, news flow or shifts in sentiment, when there is a material difference between the economic impact of an event and the market's perception of the economic impact as reflected in movements in its share price. However, lower prices alone do not necessarily mean that there are attractive buying opportunities. If the circumstances facing a company change, stock valuations can also change quite materially. Valuations falling to reflect a change in the factors affecting company worth do not necessarily result in value-based investment opportunities. Indeed sometimes circumstances can change dramatically and stock prices can in fact respond *too little* given the change in facts. Further, stocks that were expensive based on overly optimistic future assumptions may decline and still not represent an attractive opportunity to the value-based investor, if in fact they have not declined enough.

Ordinarily, when a market experiences a significant decline one would expect to see a number of value-based opportunities emerge because the likelihood is high that there is good market breadth in the decline. In other words, the index is falling because the majority of its constituents are falling and it would be rare that most of these stocks suddenly face materially different circumstances warranting such price declines. However, as we discussed in the November newsletter, at present the Australian market is a particularly unusual market. The top dozen stocks make up almost half of the ASX200. And many of these stocks face considerable headwinds and have experienced vastly changing circumstances in the last 11 months. In other words, it is not a fait accompli that the declines are unjustified. To provide a very brief and arguably overly simplistic synopsis:

- The banks have faced pressure to increase capital and restrict residential property lending, leading to lower future revenue growth and earnings dilutive capital raisings across the sector.

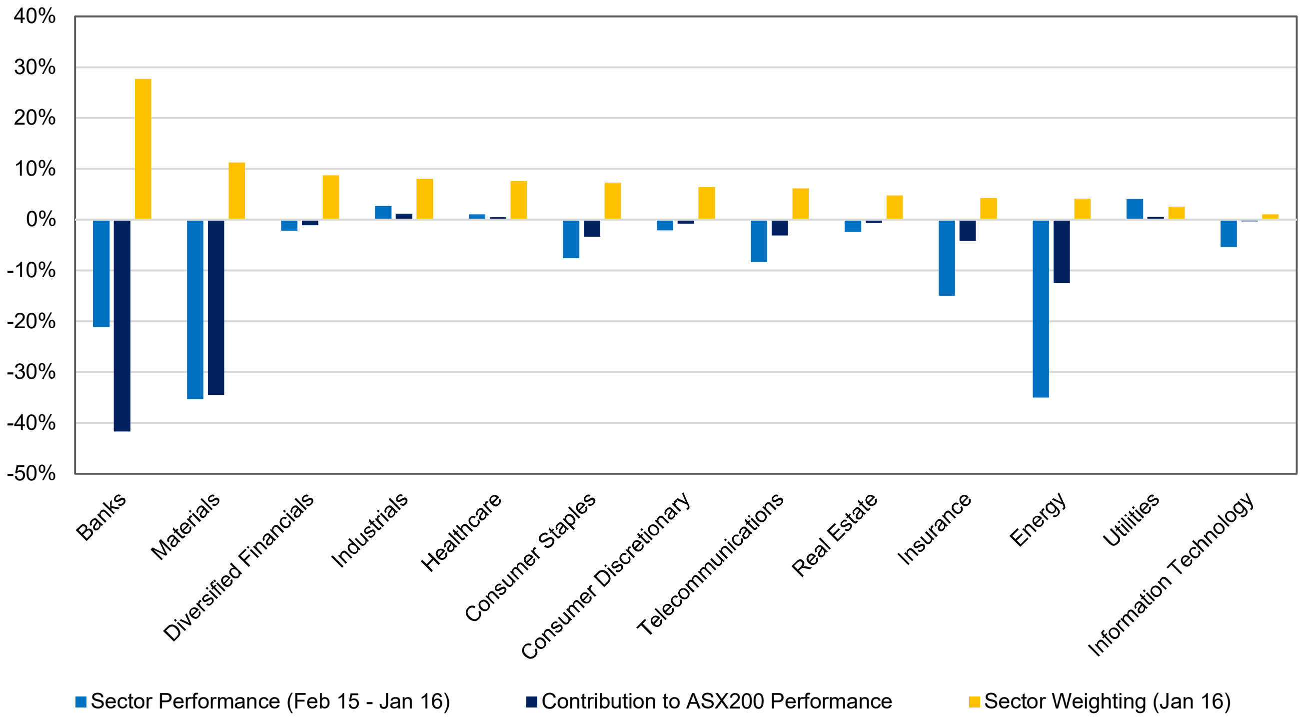
- The large mining companies have been affected by slower growth in China, resulting in considerably lower commodity prices than was even thought possible by many in February 2015.

- The large energy companies have been hit by lower oil and gas prices resulting from excess supply and a reluctance by the major players to cooperate as they have done historically in restricting production.

- The supermarket retailers have been subject to increased competition resulting in lower prices for consumers, translating into lower profit margins for the major players.

If we look at the cause of the index declines (see the chart below), it should be no surprise to see that the major detractors from performance over the 11 month period discussed have been the banks, materials and energy sectors, which combined accounted for 88.7% of the 15.6% fall in the ASX200, despite constituting only 43% of the index. This contribution rises to 92% if we include the consumer staples sector, which is dominated by Woolworths and Wesfarmers. Somewhat remarkably, if we include dividends and distributions, quite a number of sectors, representing 38% of the market, actually generated positive returns for investors over the period, including the utilities, industrials, healthcare, real estate, consumer discretionary and diversified financials sectors. The conclusion that we draw is that the sectors that have been facing significant headwinds and in many instances declining earnings have been justifiably declining, and the sectors that have not been facing headwinds and have been experiencing low or modest growth in line with Australia's recent modest economic growth have been relatively flat over the period.

Sector Contribution To ASX200 Index Return



Whether the declining sectors have fallen too far should be a question answered based on the merits of the companies in question and the factors affecting these companies as currently known. At present we are not seeing a huge number of particularly compelling value-based opportunities. If we do, we will be ready and willing to invest, irrespective of the market conditions. We believe the current period warrants continued caution and an investing approach based on sound logic, as opposed to decisions based solely on the fact that some prices have fallen a considerable way. We believe that using past prices alone as a basis for investment rarely proves to be a successful long term investment strategy.

Should a particular company meet our investment criteria, our approach is to estimate the company's intrinsic value based on known facts and quite independent of the stock's current market capitalisation or share price. We then look to purchase a stake in the company when the stock trades at a reasonable discount to our fair value estimate. A value-based investor looks for a discount to the current estimate of fair value because they understand that their assumptions may prove incorrect or circumstances may change adversely affecting valuation. This is why the discount is referred to as a margin of safety. We think such an approach should lead to satisfactory returns for investors over the medium to long term.

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.

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