Auscap Long Short Australian Equities Fund Newsletter – January 2017

The Auscap Long Short Australian Equities Fund is now registered (ARSN 615 542 213) and is open to retail investors. The Fund is available on select leading platforms. 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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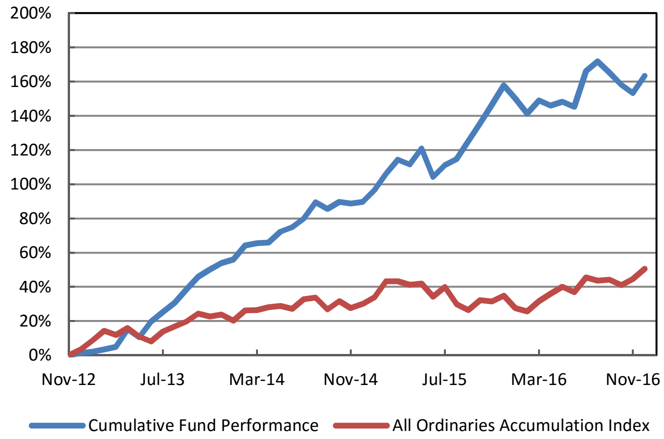
Welcome

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 Australian property and the price level of domestic residential real estate.

Fund Performance

The Fund returned 4.00% net of fees during December 2016. This compares with the All Ordinaries Accumulation Index return of 4.17%. Average gross capital employed by the Fund was 141.5% long and 13.3% short. Average net exposure over the month was 128.2%. At the end of the month the Fund had 36 long positions and 8 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
December 2016	4.00%	4.17%
Financial Year to date	7.40%	9.97%
Calendar Year to date	2.18%	11.68%
Since inception	163.45%	50.59%

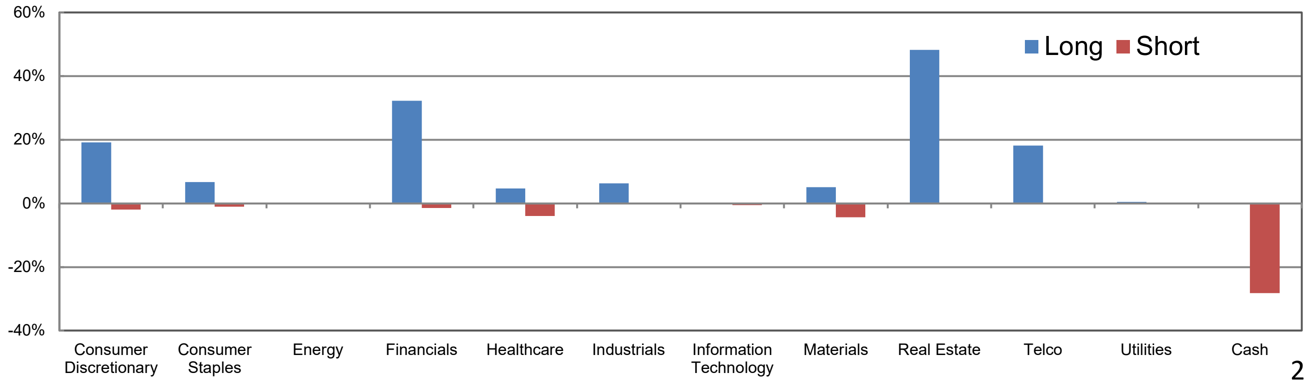
Fund Exposure

December 2016 Average	% NAV	Positions
Gross Long	141.5%	36
Gross Short	13.3%	9
Gross Total	154.8%	45
Net / Beta Adjusted Net	128.2%	87.2%

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							7.40

Sector Exposure - December 2016



Is Australian residential property expensive?

In the last three newsletters we discussed how risk management frames our approach to investing. Risks exist for every investment whether we acknowledge the risks or not. Risks that have not appeared for a long time can be ignored by investors or even assumed not to exist. To some extent we believe that the current thinking around the residential property market is illustrative.

In Australia, residential property is considered the safest of all assets. Residential property prices have not experienced a broad decline since 1991. Because property has not fallen for such a long time, the risks involved in investing in property are often assumed to be low. In our opinion, the lack of a meaningful correction in property prices over such a significant length of time is more likely to imply that the risk might be quite high, because excesses in the system have been allowed to build for such a long period. Similarly the fact that growth rates in house prices have exceeded growth in household income indicates to us that prospective residential housing returns will be significantly lower going forward. But many draw the opposite conclusion, that the historical growth rates are *evidence* that house prices should continue to grow at those rates in the future. The inference is that *past returns* tell us something about *future returns*. This extrapolation bias carries considerable risk.

National property price growth appears to have two main drivers, national household income growth and leverage. Over the very long run we might assume that leverage levels oscillate within a range, dependent on the availability of credit and sharing an inverse relationship with the level of interest rates. If that is true, then in the very long run property price growth should reflect growth in incomes. But this has not been the case in the domestic residential market. Property prices have outstripped household income growth by a considerable margin for some time.

The probability that residential property prices are currently elevated appears to us to be quite high, based on a number of very favourable drivers that are present, including:

- very low interest rates and therefore borrowing costs;
- high debt levels (closely correlated with declining interest rates);
- solid employment levels (the current unemployment rate is 5.7%); and
- strong long term historic growth (currently 1.8% and 25 years without a recession).

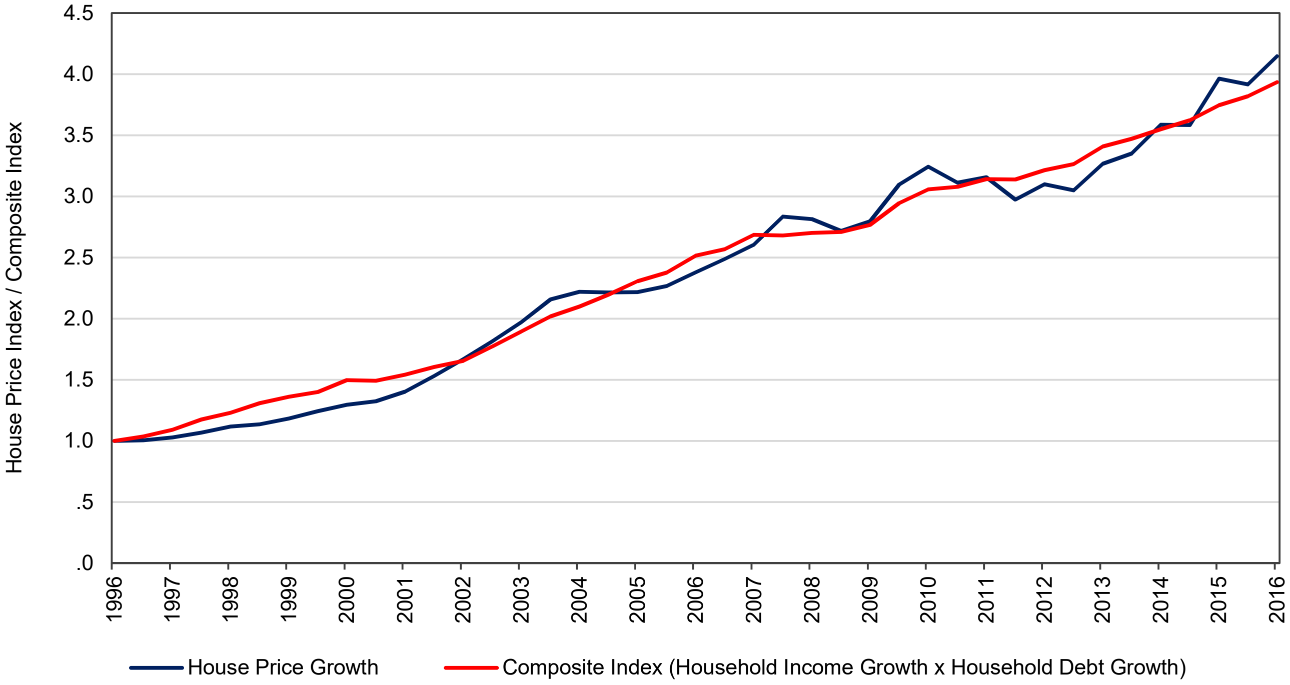
The preconditions for high property prices are in place. Prices have risen to reflect the favourable macroeconomic factors. But like a stock that is pricing in the continuance of favourable conditions, this most likely means that the downside risks associated with investing in property are elevated.

Risks to the current residential property climate include:

- with global interest rates close to the zero bound, it is hard to envisage significantly better borrowing conditions than currently exist and the risk that interest rates rise over the medium term could be significant;
- unemployment could rise from current levels;
- domestic economic growth probably has more natural headwinds than tailwinds over the medium term, especially when compared with recent history; and
- debt levels are high in the context of historical household leverage ratios and may fall over time, meaning that any deleveraging would most likely have a negative impact on prices.

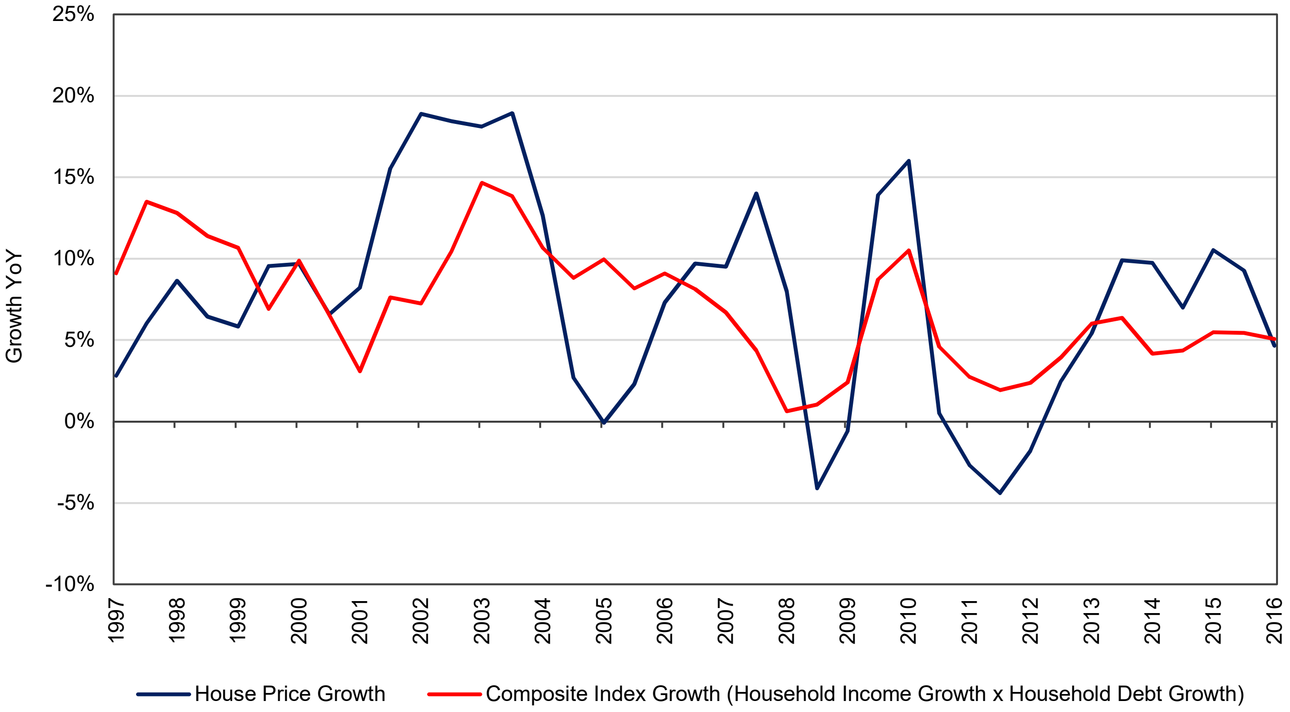
We analysed the property market against the two factors we assumed would be the predominant factors affecting property prices, household incomes and debt levels. Below is a chart comparing property price growth against a composite index of the two factors.

House Prices vs Composite Index



It appears that over the last 20 years the correlation between property prices and the composite index is very high, implying what would appear to be logical, that property prices are primarily a function of household income growth and growth in leverage. The short term moves in the composite index also mirror the short term growth rates in house prices, as shown below.

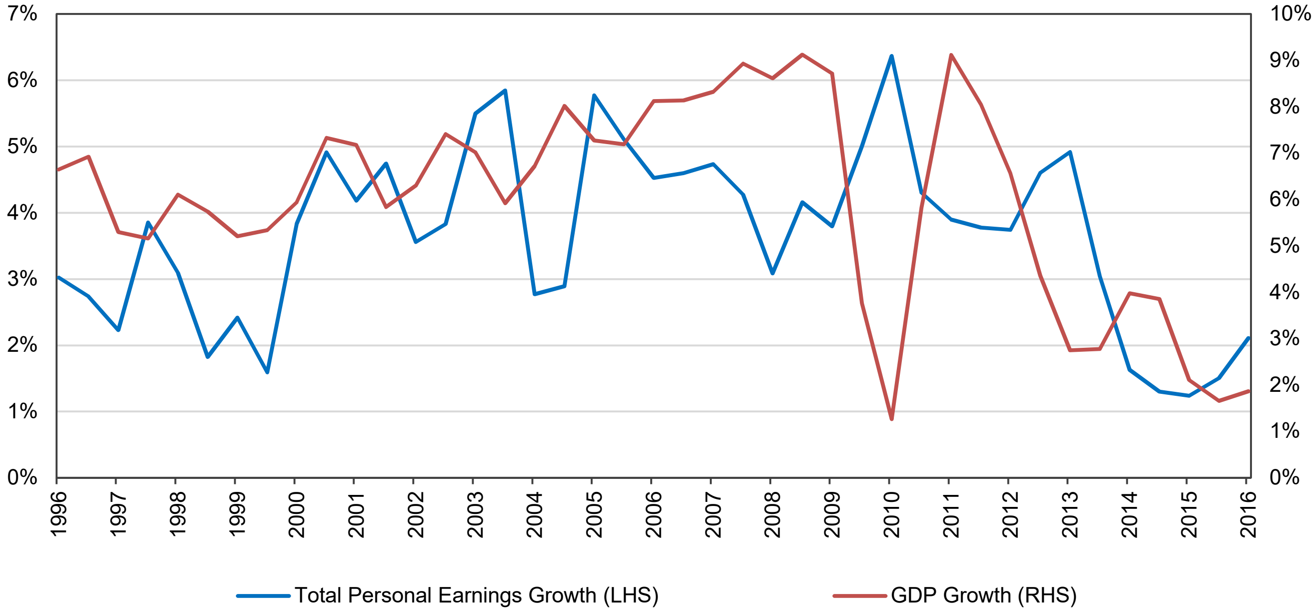
House Price Growth YoY vs Composite Index Growth YoY



The charts demonstrate visually what we know to be true, that property prices have grown by 7.4% per annum, a growth rate many take comfort from in making assumptions around future growth. But the charts also imply that this has been a function of both growth in household income (which has been circa 3.7% pa) and the growth in household debt (which has been circa 3.3% pa).

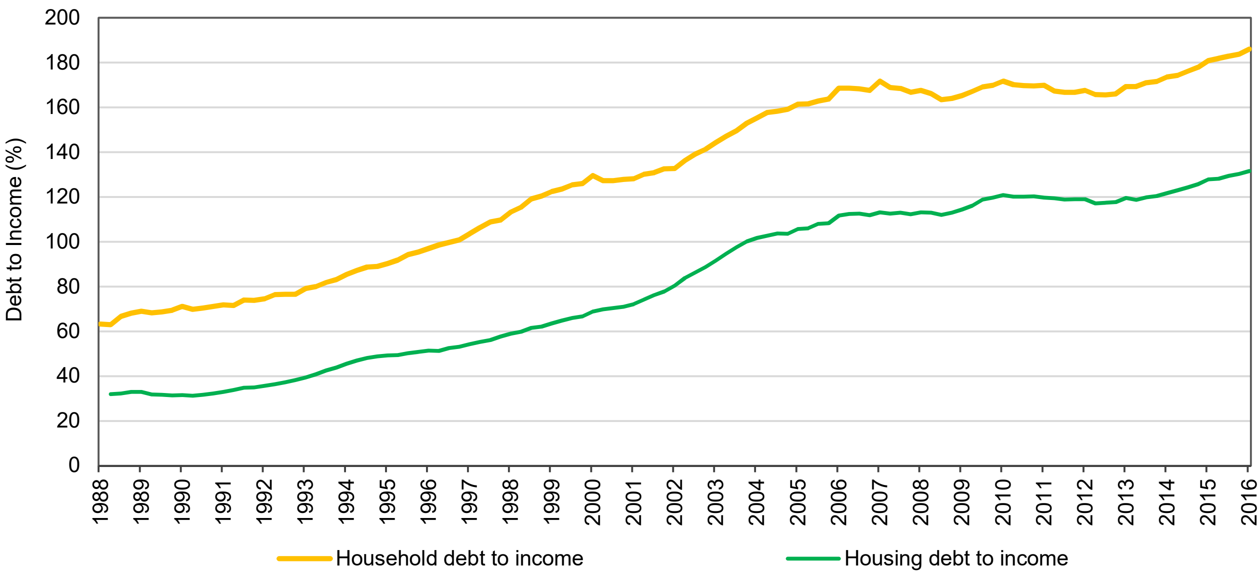
Analysing this situation as though residential property prices were a stock, we would try to form sensible expectations around household income growth and growth in leverage in the future. Household income growth is to a large extent tied to GDP growth, which we expect to be modest over the medium term. Recent growth rates have been lower than historical growth because of headwinds facing the economy that we expect will continue.

Total Earnings Growth vs GDP Growth



On the other hand, leverage levels have risen as interest rates have fallen. We doubt that household borrowing costs can fall substantially from here, implying that growth in household debt levels may be limited.

Australian Debt to Income Ratios



If this is the case, the best house price growth we might expect is for property prices to grow in line with historical household income growth. But there are a many downside scenarios that are also possible. Household income might grow more slowly should Australia face periods of slower or even negative growth. The fact that there has not been a nationwide decline in GDP in 25 years implies the risk of such a scenario is elevated, not reduced. It may not occur, but we can confidently propose that this scenario is not being considered or assessed by the majority of households in the same way it was in 1992, immediately after the last broad decline in Australian residential property prices. Household leverage may need to decline should interest rates rise. If this were the case, falling leverage may drag on house price growth, rather than add to it as it has for the last 20+ years. If the decline in leverage is greater than growth in incomes, property prices may actually fall. Certainly our conclusion would be that a continuation of the 7.4% per annum growth in household prices witnessed over the last 20 years seems extremely unlikely in the absence of borrowing costs continuing to fall, which we see as limited given where interest rates are currently.

Residential property price growth is a favourite domestic topic of discussion both in the media, at the dinner table and in many social settings. We acknowledge that we are not residential property experts. The Fund is not invested in residential property. Our analysis is simply a study of the data and is provided to readers as an example of our assessment of investment opportunity and risk. Over time we aim to attract investors who understand and share our philosophy and approach to stockmarket investment.

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. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

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