



Auscap Long Short Australian Equities Fund Newsletter – January 2018

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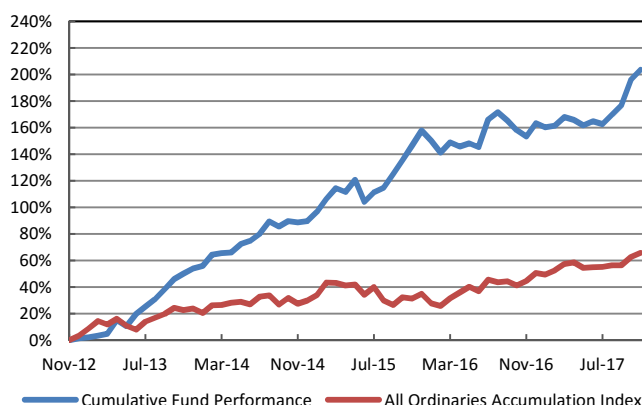
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Welcome

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 the risks of corporate diversification when an inferior asset is added to a high quality business.

Fund Performance

The Fund returned 1.56% net of fees during December 2017. This compares with the All Ordinaries Accumulation Index return of 2.03%. Average gross capital employed by the Fund was 116.7% long and 1.9% short. Average net exposure over the month was 114.4%. Over the month the Fund had on average 30 long positions and 5 short positions. The Fund’s biggest stock exposures at month end were spread across the real estate, financials and consumer sectors.



Fund Returns

Period	Auscap	All Ords
December 2017	1.56%	2.03%
Financial Year to date	16.48%	9.31%
Calendar Year to date	17.10%	12.39%
Since inception	208.51%	69.24%

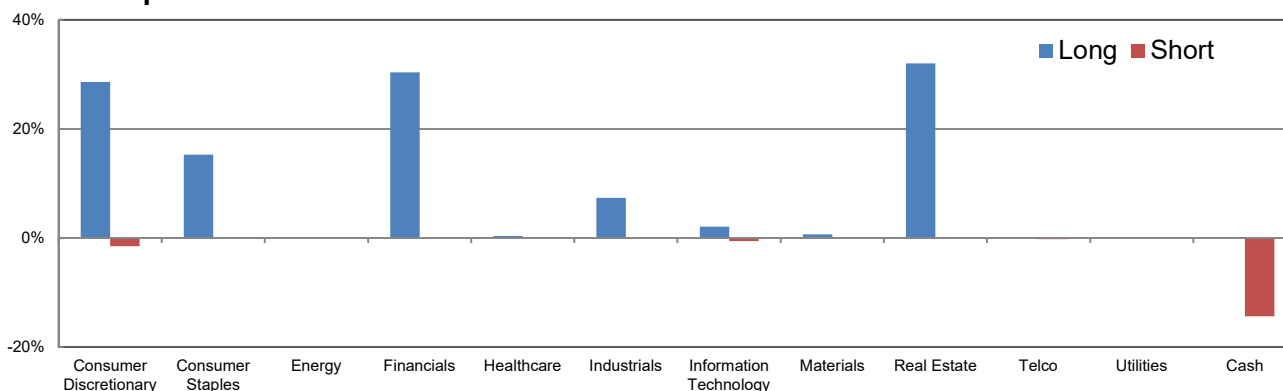
Fund Exposure

December 2017 Average	% NAV	Positions
Gross Long	116.7%	30
Gross Short	1.9%	5
Gross Total	118.6%	35
Net / Beta Adjusted Net	114.4%	73.8%

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)	2.75	2.53	6.96	2.58	1.56							16.48

Sector Exposure - December 2017



Delineating Diversification From Deworsification

Corporate diversification is a strategy involving entering a new market, industry, geography or product category that the business does not operate in. Diversification can be organic, the process of building this new business from scratch, but frequently corporate diversification involves buying an established company in that market, industry, geography or product category. This sort of diversification by acquisition has a close and often proximate cousin, affectionately known as deworsification. Deworsification might be defined as the process of a business acquiring an asset that is inferior in quality to the company's existing group of assets. It may also involve selling the company's best asset to reinvest in inferior assets again leaving shareholders with exposure to lower quality assets than if management had done nothing. Unfortunately financial history is littered with countless value-destroying examples of deworsification.

The rationale given for deworsification is often confused at the time of the transaction. Some of the typical but spurious claims made by management to justify an acquisition include:

- diversifying the portfolio – shareholders can do this by simply purchasing shares in other great businesses;
- earnings accretion due to buying an asset at a lower multiple of earnings – however this will often occur because lower quality businesses trade at lower multiples and hence higher earnings yields, but the business as a whole is now of lower overall quality; and/or
- earnings accretion due to the effects of financial or operating leverage – a transaction that increases leverage will appear to increase earnings per share, however there will generally be no mention of the corresponding increase in risk that shareholders now face.

Some of the motivations behind such a transaction are often more easily identified than the logic of said transaction:

- management may want to manage a larger business – this is commonly known as empire building;
- management may want to maximise the short term share price during their tenure, since it often determines their variable short and long term compensation; and/or
- management may have spare capacity because the business is running efficiently and so they have been spending time focused on what else they can do, often consulting their advisers (we strongly recommend more holidays instead).

This last issue might be one that is common to both CEOs and fund managers. Managers of capital often feel compelled to do something if they have excess cash, such as buying an asset or making an acquisition. This is especially so when their business is operating smoothly leaving them with excess time and an under-utilised team. As a consequence, a lot of value has been destroyed by management teams that have an inability to sit still, hold or return any excess capital to shareholders and patiently wait for the right investment opportunities. Sellers of assets must see these managers who are desperate for activity or growth coming from a mile away.

A variant of deworsification is selling the best asset a company owns, simply because another party is willing to pay a full price at a given moment in time. Good businesses continue to grow in value over time. What looks like a full price today can look anything but in a short number of years. The true aim of almost any exercise in selling a company's prized asset is to maximise the share price in the short term. That might be beneficial to short-stay CEOs and/or shareholders, but not good for long term holders of the business. The best asset is gone, cannot be replicated and someone else will be the beneficiary for years to come. The money is received and distributed, or worse still poured into the development or acquisition of inferior assets, and shareholders no longer have the benefit of the asset's great cash generation.

Such an approach reminds us of Blaise Pascal's famous quote, "all of humanity's problems stem from man's inability to sit quietly in a room alone". We might paraphrase to make the quote appropriate for investors and suggest that many shareholder problems are created from management's inability to sit still and do very little in terms of corporate activity.

The problem is of course exacerbated by the enormous number of parties willing the impatient CEO to do something. All of the bankers, lawyers and consultants get paid based on activity, which only worsens the situation for shareholders as all of these transaction fees and stamp duty costs are borne by shareholders. While we are very confident that these advisers focus on giving good advice to their clients, avoidance of the obvious conflict of interest is incredibly difficult. Incentives drive a lot of human behaviour, and recognition of this is critical. If an adviser will not get paid for advising against a deal, justifications for the transaction should be expected to be seen more so than reasons for not doing it, particularly with a motivated CEO in place.

We often question why the fund managers who represent large shareholdings are not more frequently a part of the discussion around the acquisition and disposal of major assets. We suspect many major long term shareholders would be happy to be consulted, once the appropriate legal restrictions or “wall crossings” are in place with respect to receiving any confidential information, for significant proposed transactions. These are the parties that should be involved in the decision. They are, first and foremost, the owners of the assets. They have no hidden agendas, they receive no additional benefit from activity. They are simply motivated by value creation. Some acquisitions are sensible and can create genuine shareholder value. Approaching the right long term investors of a business seems a sensible strategy for receiving sound advice. As the famous Buffetism goes, “don't ask your barber if you need a haircut”.

Fund managers are informed and incentivised to get the right outcome for shareholders. What's more, they spend their whole working day, every day, determining appropriate capital allocation. In fact we would go so far as to say that the area of expertise of a good fund manager *is* capital allocation. And yet they frequently seem to be left out of the discussion, only involved when the transaction is a *fait accompli*. We encourage the management teams of businesses of which we are a shareholder to reach out to us if they are considering a major transaction. As a genuine long term shareholder we would be only too happy to provide an independent perspective on any proposed transaction.

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