Auscap
Asset Management

Auscap Long Short Australian Equities Fund Newsletter – October 2015

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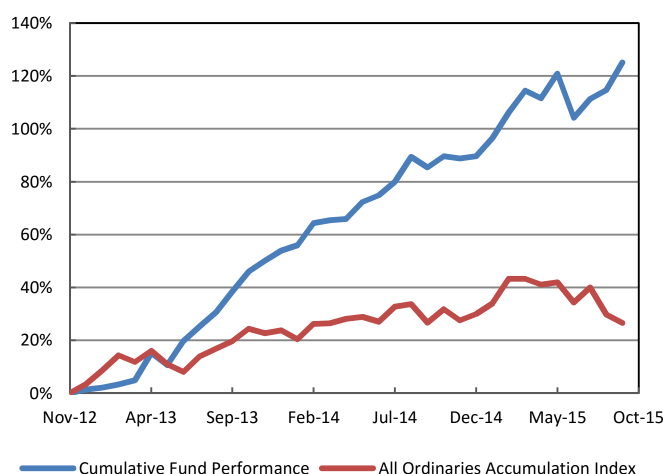
Welcome

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 Fund's variable market exposure and why we think it is a sensible approach to investing.

Fund Performance

The Fund returned 4.82% net of fees during September 2015. This compares with the All Ordinaries Accumulation Index return of negative 2.50%. Average gross capital employed by the Fund was 101.8% long and 26.4% short. Average net exposure over the month was 75.4%. At the end of the month the Fund had 30 long positions and 11 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, consumer staples, healthcare, information technology, materials and energy sectors.



Fund Returns

Period	Auscap	All Ords
September 2015	4.82%	(2.50%)
Financial Year to date	10.23%	(5.79%)
Calendar Year to date	18.69%	(2.67%)
Since inception	125.08%	26.50%

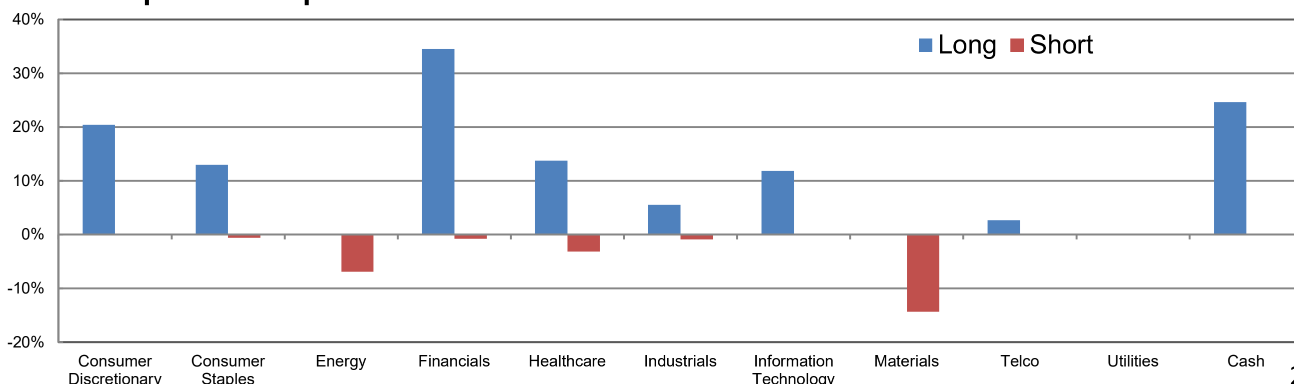
Fund Exposure

September 2015 Average	% NAV	Positions
Gross Long	101.8%	30
Gross Short	26.4%	9
Gross Total	128.2%	39
Net / Beta Adjusted Net	75.4%	50.2%

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										10.23

Sector Exposure - September 2015



To Be, Or Not To Be, Fully Invested

Recently we have seen an immense amount of coverage in the market and the media about whether the stockmarket is heading higher or lower. The familiar bull and bear pictures have been appearing frequently in the financial press as various participants provide their predictions on the market's direction over the coming days, weeks, months and years. We are not convinced that anyone will successfully tell you where the market will be tomorrow, let alone weeks or months into the future. It begs the question, if predicting the direction of the market is futile, why are we not always fully invested?

At first glance, not having a view on the future direction of the market might appear to be at odds with running a fund that has variable market exposure. Indeed, the Auscap Fund is not committed to being fully invested at all times. As readers would note from page 2, the Fund's net exposure was 75.4% over the course of September. Our beta adjusted exposure, a closer proxy for the Fund's leverage to broad market moves, was just over 50%. Given our value bias, we would suggest our exposure to the market was even lower than this.

Some participants suggest that the only way of investing sensibly, given the futility of trying to determine the direction of the broader market, is for fund managers to consistently remain fully invested. Does the fact that we are not fully invested imply that we are trying to predict the direction of markets? Our answer is most certainly no.

As a manager we are focused on absolute risk-adjusted returns. We do not predetermine our market exposure, it is entirely dependent on the opportunity set present in the Australian stockmarket. When we find a lot of compelling investment opportunities, our net exposure rises. When we are not finding a lot of value, and perhaps have more success in identifying short opportunities, the Fund's exposure falls. To us it makes more sense to focus on buying stocks when they are cheap and selling them when they are expensive than worrying about the future direction of markets or whether we are fully invested at all times. We have no focus on single stock or sector weightings in any index, and try to reduce investing into a reasonably straightforward question. Does an investment opportunity present an attractive risk-adjusted return? This requires us to assess both the prospective return and the potential risks associated with an investment.

Prospective Return Considerations

To calculate prospective return is not an easy task. We do not have price targets for securities that we own. Instead, for every company we assess and reassess the current earnings profile and the likely growth in those earnings under modest assumptions to determine whether this total return (cash earnings + growth in earnings) is acceptable. We have a valuation range for what we view as "fair value" for a stock at a particular point in time, but never is this valuation a single number. We focus on buying what we believe are good, cash flow generating companies at attractive prices. We use valuation tools like earnings yield and price to earnings (P/E), enterprise value to earnings before interest and tax (EV/EBIT) and price to book (P/B) ratios as valuation guides.

We are not huge believers in the discounted cash flow (DCF) models that suggest a single answer to the valuation question. DCFs tend to be very reliant on two inputs. One is the growth in earnings assumed over the next ten plus years, and the other is the discount rate used to calculate the present value (PV) of future earnings, or the weighted average cost of capital (WACC). We believe that it is almost impossible to predict, with any degree of accuracy, what the growth might be for a particular company over the next ten years. Invariably any assumption is going to be reliant on a small number of factors that cannot be accurately forecasted. Secondly, the discount rate adopted by the valuer is critical in determining the valuation. It is our view that there is far too little consideration of risk in determining an appropriate WACC.

To use a hypothetical example, if a 7% WACC is appropriate for a group of fully tenanted office buildings, then we would not be of the view that a 10% WACC is appropriate for a mining company in assessing these alternative investment propositions. The former company is a rent collector with occasional tenancy risk, mitigated by a high number of alternative prospective replacement tenants. The latter company has commodity price risk, currency risk, energy cost risk, exploration risk, environmental risk, often sovereign risk and typically very considerable operational risk to name but a few of the potential hazards. Every day the mining company doesn't know exactly what they are going to find when exploiting a natural resource. We are certainly not of the view that a 3% difference in the WACC is an appropriate adjustment for risk, nor that a 10% WACC is a suitable discount rate to determine a valuation that the average investor wishes to hang their hat on!

Assessing Potential Risks

Risk can also be somewhat difficult to assess. We try to reduce risk by focusing on investing in companies that meet a number of criteria. The companies have to generate sustainable cashflow. Understanding the limitations of the DCF does not change the fact that the value of any business is the present value of its future cash flows. If a company is not already producing cash flows for its owners, then predicting what those cash flows are likely to be is extremely difficult and highly risky. Similarly, we find factoring in a steep growth in cash flows to be very dependent on a number of assumptions. Often it takes many assumptions to make an investment case, but only one or two of these assumptions need to be incorrect for the cash flows to be significantly lower than expected and the investment thesis invalidated. If the market is pricing a security based on optimistic cash flow forecasts, then any disappointment will be quickly reflected in the price, and normally result in capital loss. We prefer to focus on businesses that already generate substantial cash flows that should continue to grow at an acceptable rate. We would rather pay more for today's business and less for growth dependent on rose coloured spectacles.

We also focus on businesses that have been able to demonstrate that they can achieve a satisfactory return on invested capital. We think it is almost impossible to determine with certainty any company's future earnings, because these earnings are invariably linked to a number of either random or indeterminable factors. What we can assess is whether we think a company has a sustainable competitive advantage over its competitors, and how a business has performed in different environments historically. We find that past return on invested capital to be the best predictor for both future return on capital and the ability of a company to respond to changing circumstances and competitive threats.

Assessing risk is also a continual process rather than just a pre-purchase activity. We review our initial investment thesis and ongoing company performance on a regular basis. It is critical to recognise when one is wrong about the facts of the investment and exit in a timely manner. We consider capital preservation through appropriate risk management to be the platform for delivering investment returns.

The Importance of Price

Finally, price is a factor affecting both prospective return and risk. Overpaying for any business will typically prove to be a bad investment strategy. And yet price does not often appear to be the key focus for investors. Many people feel comfortable buying businesses that have the above characteristics, diligently assessing each company on these metrics, and are then happy to pay a full price for these businesses. We are of the view that most of the money on any investment is made on the purchase, in situations where the company is being sold for a discount, normally because there are one or two transitory circumstances or temporary headwinds affecting the company's earnings or investors are reacting to broader macroeconomic or geopolitical uncertainty. When assessing any company, in our view price is the most important and immediate metric to analyse, not the last consideration in the evaluation process.

We are not of the view that we have any special skill in determining the stockmarket's direction. For this reason we focus instead on the investment opportunities in front of us. If the investment opportunities are plentiful, we will try to take advantage with the end result that we are reasonably fully invested. If the opportunity set is less compelling, we are more likely to be holding higher levels of cash. In this way we think the Fund's net exposure is the output of a sensible investment strategy, rather than a predetermined input that requires immediate investment decision making.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website 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.

Auscap Asset Management

ACN 158 929 143 AFSL 428014
Lvl 24, 9 Castlereagh St, Sydney

Email: info@auscapam.com
Web: www.auscapam.com

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Prime Brokerage: Citi Global Markets
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