



Auscap Long Short Australian Equities Fund Newsletter – September 2017

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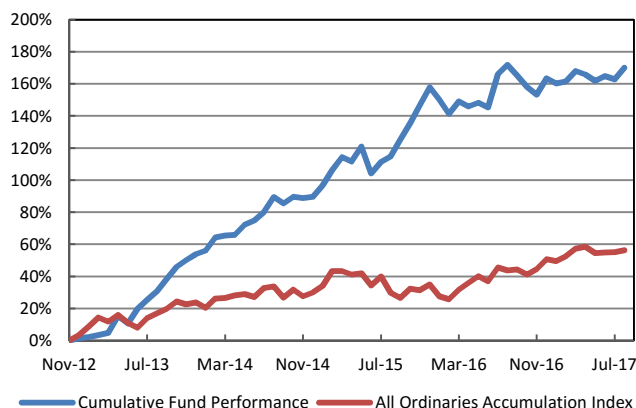
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Welcome

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 performance of the Fund during FY17.

Fund Performance

The Fund returned 2.75% net of fees during August 2017. This compares with the All Ordinaries Accumulation Index return of 0.79%. Average gross capital employed by the Fund was 99.7% long and 10.1% short. Average net exposure over the month was 89.6%. Over the month the Fund had on average 29 long positions and 8 short positions. The Fund’s biggest stock exposures at month end were spread across the real estate, financials and consumer discretionary sectors.



Fund Returns

Period	Auscap	All Ords
August 2017	2.75%	0.79%
Financial Year to date	1.96%	0.97%
Calendar Year to date	2.50%	3.82%
Since inception	170.04%	55.11%

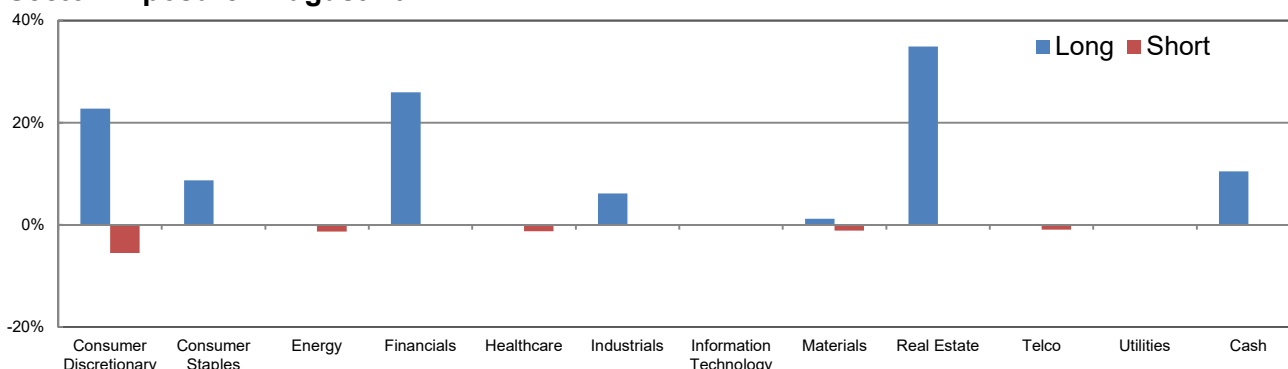
Fund Exposure

August 2017 Average	% NAV	Positions
Gross Long	99.7%	29
Gross Short	10.1%	8
Gross Total	109.8%	37
Net / Beta Adjusted Net	89.6%	51.4%

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											1.96

Sector Exposure - August 2017



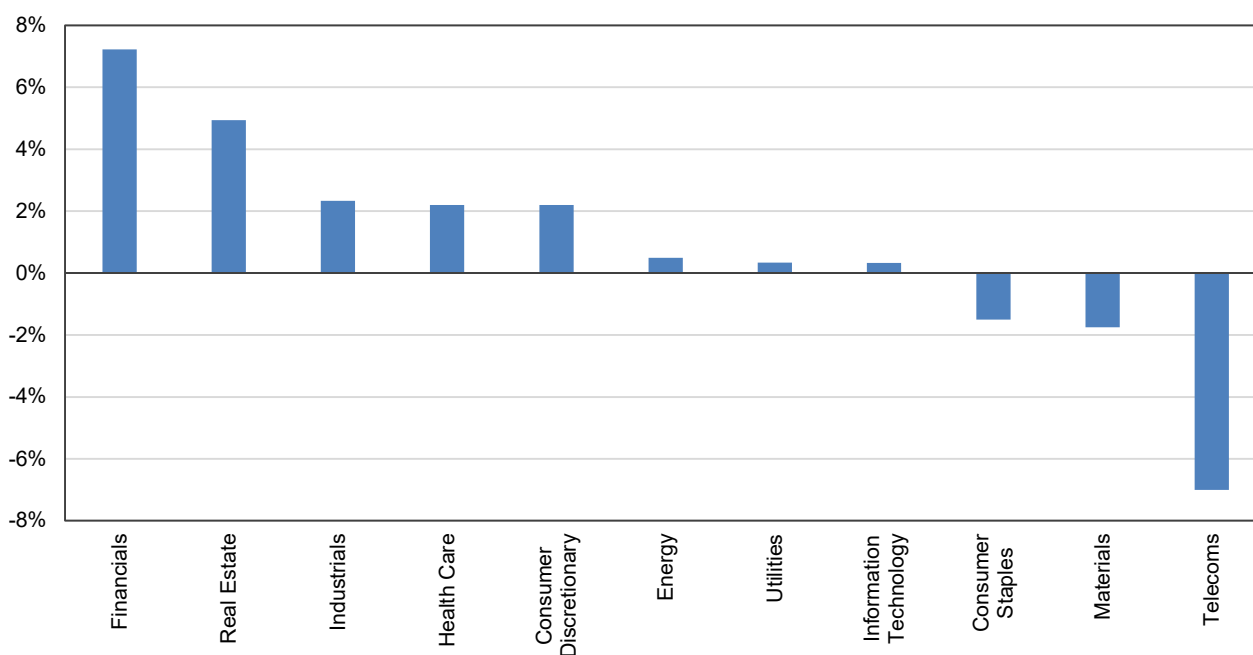
Analysing FY17 Fund Returns

Long term investors and readers of this newsletter will remember that each year we reserve the September newsletter for a candid assessment of the Auscap Fund's performance in the prior financial year. In FY17 the Fund delivered 8.0% net of fees for investors.

The past year was characterised by the following features:

- solid returns from a large number of core holdings across a variety of sectors within the Fund;
- significant deployment of capital in the period immediately following Brexit, primarily into a number of financial stocks, which generated strong absolute returns;
- a small negative contribution to returns from short positions after four years of positive contributions;
- an above average cash holding for most of the year indicating the absence of sufficiently compelling investment opportunities to warrant investment; and
- an allocation into the telecommunications sector in late 2016 that we, in hindsight, regard as a mistake and will discuss in more detail below.

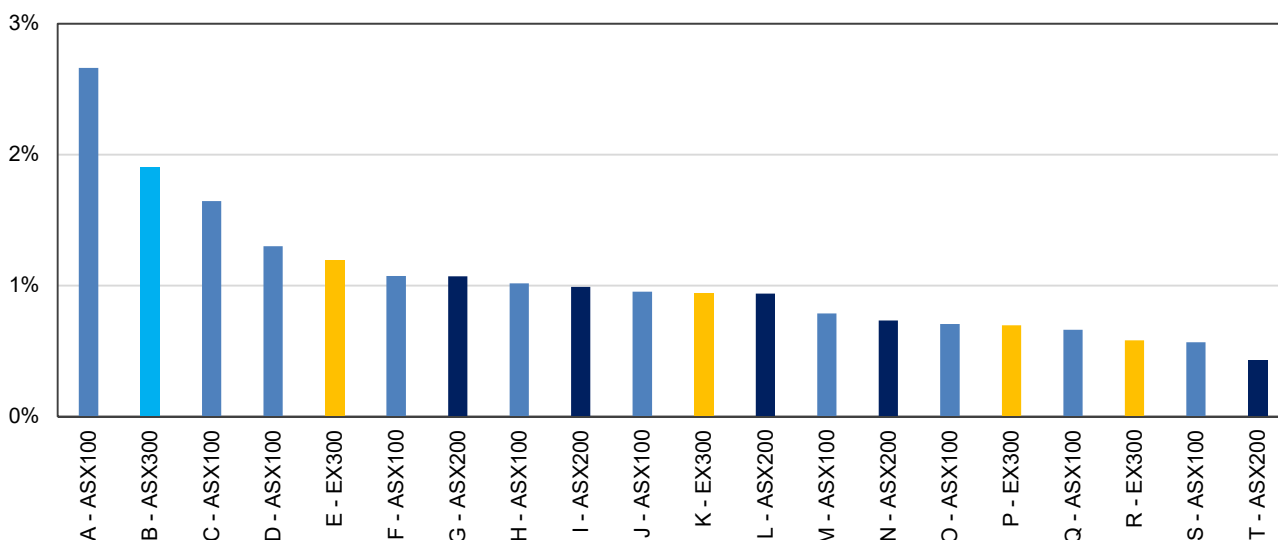
Gross Fund Returns by Sector



The result itself is only one part of the equation in analysing the decisions made, and *to us* a relatively small part at that. We are always more inclined to focus on the diligence of the process and risk management, believing that over time doing so will deliver results for our investors. To use a sporting analogy, we do not believe that a successful team runs onto the sporting field focused on what the winning margin will be. They focus on the process (doing the basic skills well, executing on the strategy and focusing on areas of relative strength) and risk management (solid defence and minimising the impact of known weaknesses). If the execution of process and risk management takes place the results over time will look after themselves. It also highlights that to confuse results with performance can be misleading. A marginal win against a strong opponent can be a better result than a huge win against a lesser one. In the market every manager will have times when conditions are favourable for their style of investing and times when conditions are less favourable. The conditions will make the manager look better or worse than the quality of their decisions. So it is the quality of the decisions that should be assessed. For this reason we like to publicly delve into the sources of positive and negative contributions over the prior year to provide transparency to our investors.

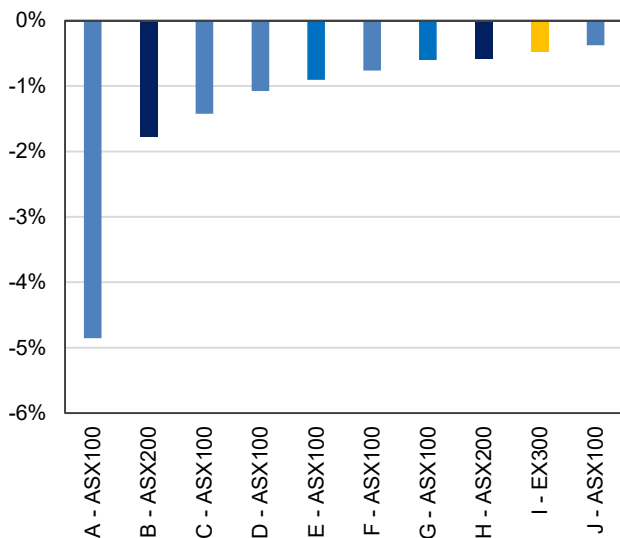
At an individual stock level there were a large number of stocks which made modest contributions to the total return delivered by the Fund. These companies are the typical high cash producing, return on capital focused businesses that we are looking for and which were purchased at attractive prices. The companies that we purchased in the weeks following Brexit are businesses that we have been actively following for years. They are large and mid capitalisation businesses that have the aforementioned financial characteristics. The fear, confusion and panicked selling that followed the Brexit decision gave us an opportunity to buy into these companies at highly attractive prices. We believe that many of these companies will continue to deliver strong returns for our investors in the years to come and most remain a core part of the portfolio.

Best 20 Single Stock Contributions to Gross Fund Performance

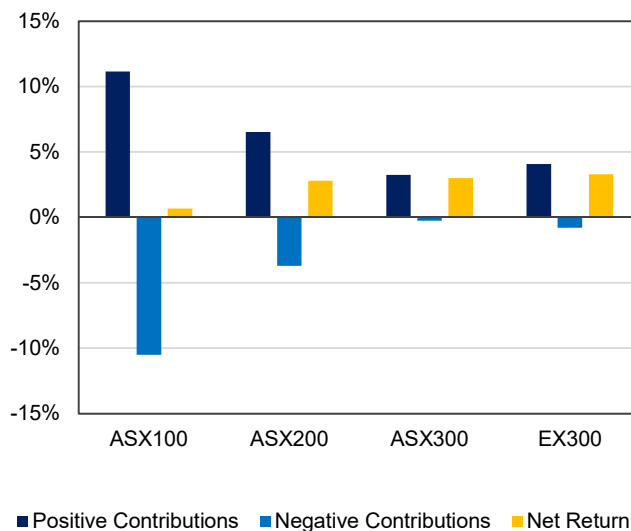


In contrast to the large number of positive contributors within the Fund, our errors were concentrated and avoidable. Unlike FY16, when there were no investments that detracted more than 1% from performance, in FY17 there were four such stocks and they hurt Fund performance. As we have often said, overall performance is frequently determined by the investments that cost you money rather than the investments you choose that perform well. By Index the Fund’s largest exposures were within the ASX100, which contributed the largest gross positive and negative performance over the year.

Worst 10 Single Stock Contributions



Gross Fund Returns by Index



Two of the four companies that detracted more than 1% from Fund performance over the year are businesses that operate in the telecommunications sector. That the telecommunications sector was facing a period of significant change and challenge due to the rollout of the NBN and increased competition across the market was well known to us. To some extent we were seduced into a typical value trap. These positions were entered into and exited entirely within the financial year and represent crystallised losses for our investors. We are disappointed by these errors in judgement and they have reiterated to us a number of investing principles that we thought we would share with our readers:

- If there is an event or change coming that will have a negative impact on company earnings, the best approach is to wait until it arrives and has been digested by all participants in the market prior to investing. Even if you think change is priced in prior to an event, the market will react when reality hits, often savagely. Assuming the market is already pricing in a particular change in market dynamics is dangerous and a typical trap for the value investor. As value investors that spend significant time analysing companies, we can sometimes forget that the risks we are thinking about today as a full time market participant may not be considered by many investors until the company's earnings are actually being impacted by the event. Being too early to invest in a company facing near term headwinds can be indistinguishable from being wrong. It is often best to wait until the company's earnings have bottomed and are growing again before investing.
- It is important to pay objective attention to market signals, irrespective of your familiarity with a business. Market signals might include insider selling, savage market reaction to small downgrades and analysts losing patience with management. If negative signals are present, pausing for thought can prove valuable.
- If the financial accounts start to reflect poor or aggressive accounting practices in any way, tread carefully and focus heavily on cashflow. The same accountants look after all the figures. If cash flow starts to come into question there is no telling how far a stock can fall. A business is worth, after all, the present value of all future cash flows, any forecast of which is based on current cash flow.
- Past price action for a particular stock is irrelevant. Do not be influenced by historical prices, multiples or valuations. They have no bearing on the current investment proposition. One can be lured into thinking something is cheap because of where it came from, only to see it halve again. This is a cognitive bias that is difficult to avoid, but recognising it is important.
- The collective market typically knows more than the individual investor. If a stock is not reverting to your view of fair value in the medium term, ask why. Recognising that past familiarity with a company can lead to overconfidence can assist in reducing or exiting a poorly performing position and thereby preserving capital.
- When you are wrong, cut immediately and entirely. Do not leave a residual position "in case you're right", just exit. As Charlie Munger said at Berkshire Hathaway's Annual General Meeting in 2000, "*One should recognise reality even when one doesn't like it*". Cutting these positions in April 2017 has saved the Fund from further capital loss.

There were some broader reminders from the year, unrelated to the specifics of the telecommunications investments, that we also thought we would share:

- Good investing does not have to be difficult. Wait for the no-brainers. As Bill Gates described to Fortune magazine in 1996, "*Being good with numbers doesn't necessarily correlate with being a good investor. Warren (Buffett) doesn't outperform other investors because he computes odds better. That's not it at all. Warren never makes an investment where the difference between doing it and not doing it relies on the second digit of computation. He doesn't invest – take a swing of the bat – unless the opportunity appears unbelievably good.*"

- Be patient and comfortable with significant levels of cash. Not only does it provide you with terrific optionality but the remainder of the equities exposure within the Fund will deliver sufficient returns if the investment theses are correct.
- Make time to read broadly, from the minutia of company annual reports through to historical books on finance. *“To be a successful investor, a person must regularly devote the necessary time and effort. Even if you once felt that you knew a lot about investing, it does not mean your skills are current. Maintaining a circle of competence requires constant work and diligence.”* “Charlie Munger – The Complete Investor”, Tren Griffin, 2015.

To some, this newsletter may appear to be dwelling heavily on the mistakes made within the year, forgetting that returning 8% net to our investors is not a poor outcome. These thoughts should be taken in the context of the returns delivered, however we agree with Charlie Munger’s comments at Berkshire Hathaway’s 2011 Annual General Meeting when he stated that *“I like people admitting they were complete stupid horses’ asses. I know I’ll perform better if I rub my nose in my mistakes. This is a wonderful trick to learn.”* We will, like all investors, make mistakes over time, but we hope not to make the same mistakes and we aim to minimise their cost. From our perspective this is the key to good investing.

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