



## Auscap Long Short Australian Equities Fund Newsletter – March 2014

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**Welcome**

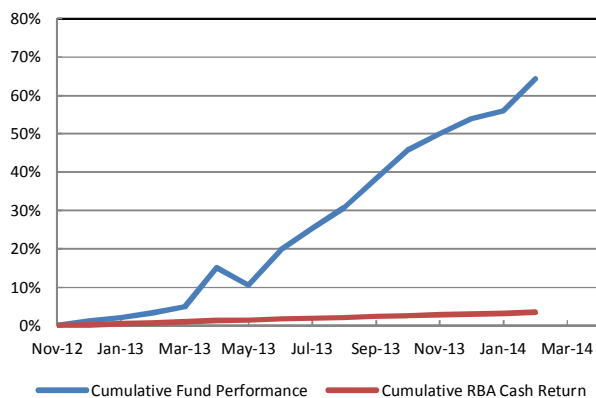
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (Fund) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we discuss our thoughts on investment positioning and market exposure, including why we have both long and short positions, why we have a long bias over the market cycle and why we generally aim to have surplus liquidity in the Fund.

**Overview**

The Fund was launched in December 2012 and targets strong absolute returns in excess of the RBA Cash Rate. The Fund focuses predominantly on fundamental long and short investments while utilising a multi-strategy approach to take advantage of shorter term market opportunities to increase returns, hedge the portfolio, protect capital and minimise volatility where prudent. The Fund will typically have 25-45 positions primarily in liquid stocks in the ASX200. Further information, including access for sophisticated investors to the Fund's Information Memorandum, is available at our website [www.auscapam.com](http://www.auscapam.com). Enquiries can be directed to [info@auscapam.com](mailto:info@auscapam.com).

**Fund Performance**

The Fund returned 5.32% net of fees during February 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 102.0% long and 23.8% short. Average net exposure over the month was +78.2%. At the end of the month the Fund had 33 long positions and 5 short positions. The Fund's biggest stock exposures at month end were spread across the consumer discretionary, financials and telecommunications sectors.



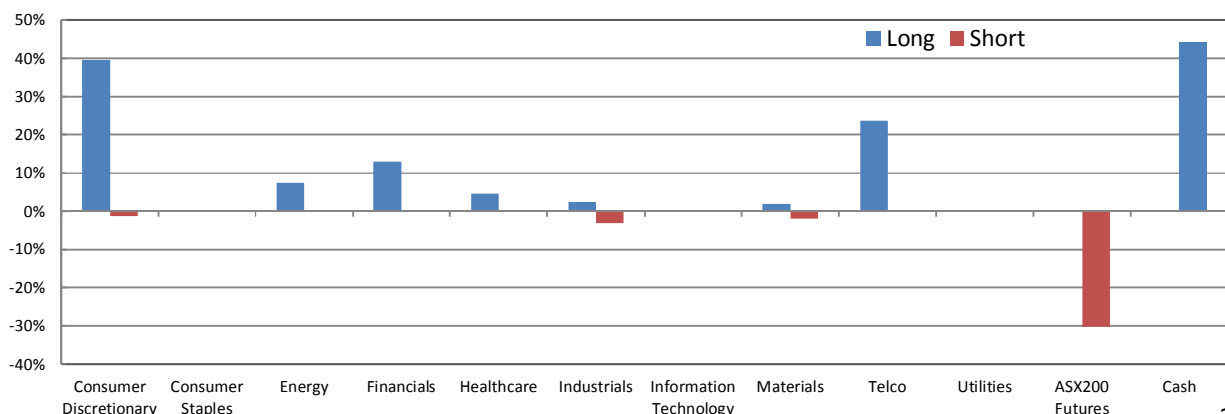
**Fund Returns**

Period	Auscap	Benchmark
February 2014	5.32%	0.21%
Financial Year to date	37.22%	1.70%
Since inception	64.28%	3.45%

**Fund Exposure**

February 2014 Average	% NAV	Positions
Gross Long	102.0%	31
Gross Short	23.8%	9
Gross Total	125.8%	40
Net / Beta Adjusted Net	78.2%	60.4%

**Sector Exposure - 28 February 2014**



## **The Long And The Short Of It – Our Investing Biases**

To the extent an investor decides to outsource the responsibility for their equity markets investments, the type of professional money manager one chooses is a question for each individual. It takes time to become comfortable with the way a manager thinks, invests and performs. Indeed no two managers are the same and we believe it is quite important that our investors understand a few of the key aspects of the way that Auscap manages investor funds. The Auscap Fund is a long short Australian equities fund with a value focus. Those who have read our newsletters from inception might also have noticed that we have a net long bias with a preference for surplus capital. In this newsletter we try to explain the logic behind why we are, in general, positioned this way.

### **Long & Short Positions**

There are frequent opportunities to generate returns on both the long and short side of the market. Establishing a long short fund allows us to take advantage of both rising and falling stock prices. Long investing is buying shares in listed companies. We look for quality businesses trading at prices that we consider to represent good value that have sustainable and growing earnings over time. We invest predominantly in companies that we are familiar with in terms of the products or services they sell. For the majority of these companies we take at least a three year time horizon.

Shorting is the process of selling shares in companies that we consider expensive, with the aim of buying back those shares at a lower price at a later point in time. We typically look for companies with declining earnings, structural challenges and/or questionable business models. In a rising market there often appears to be little need for short positions. However, in markets that trend sideways or downward we believe that short positions both add to the Fund's returns and act as a hedge for adverse market-related movements in the long positions in the portfolio. Hence the short positions provide a number of benefits that we think justify the time we spend researching and managing them.

### **Discretionary Net Exposure**

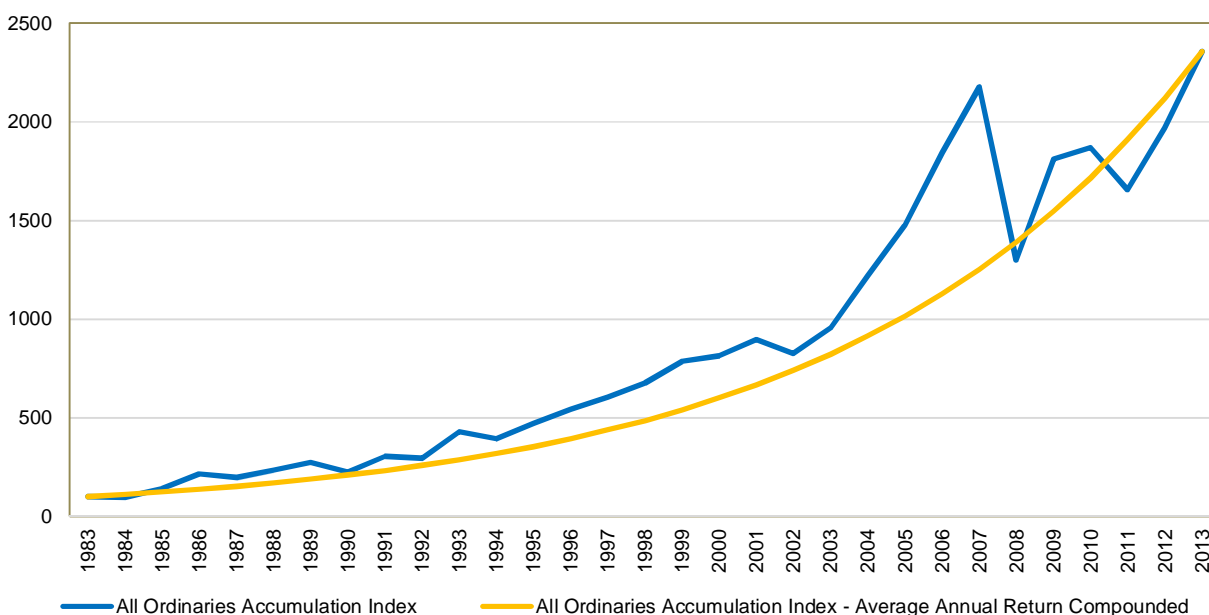
There are different types of long short funds. Some are 130/30, which means they have 130% of the capital base invested long against 30% short, for a net exposure of 100% long. Some are market neutral funds, which have the same gross long and short exposure. The manager is therefore agnostic as to whether the market rises or falls because they are trying to generate returns through the performance of one stock relative to another, typically in the same industry. Some are short funds, which means their shorts are, in aggregate, greater in size than their longs. Some are discretionary in their positioning, but invariably most of these discretionary funds have a particular bias.

The Auscap Fund falls into the discretionary category, with the flexibility to be positioned net long, neutral or short. We expect the Fund's net exposure to change depending on the economic and market circumstances. We think this is sensible, because the constraints of a fund that has a set market position, such as those committed to being always fully invested, appears to us as setting a rigid framework in what is a fluid and dynamic investing environment. There are times when we want to be fully invested, with many stocks selling below our calculation of intrinsic value. At other times, when there is an absence of compelling investment opportunities, we believe it sensible to hold significant levels of cash. Similarly there are occasions when many stocks appear expensive and vulnerable to changing economic circumstances. Shorting opportunities may appear abundant. There are other times when we feel that having any short position is dangerous and likely to increase, rather than reduce, overall portfolio risk. Shorting stocks during a roaring bull market might be one such example. Ultimately we want to manage the Fund in a way that we think maximises the returns from equities for our investors. Our view is that the best way for us to do this is through having, for the majority of the time, a net long position (ie being long biased) with meaningful surplus capital.

**The Long Bias**

If history is any guide, markets trend higher over time. Over the last 30 years, this trend has resulted in the All Ordinaries Accumulation Index appreciating, on average, 11.1% pa (including dividends). This reflects positive economic growth over time. Together inflation, an increasing population and productivity improvements drive higher prices, demand and output, which in turn leads to rising nominal revenues and profits. It therefore makes sense to us that we should have a long bias. We like investing in quality companies that generate consistent, strong and growing earnings. And we want to own these companies *all* the time. Why? Because every day they are worth more to us than yesterday. They have produced an extra day of cash flow, and yet the future cash flows of the business look almost exactly the same as yesterday's cash flows, only we have an extra day of profit in the bank. If investors want a carry trade, we think it's owning good businesses. This is because as an owner of the business, every day you have more cash than the day before and, typically, exactly the same opportunities to generate returns.

**Actual vs Annualised All Ordinaries Accumulation Index Growth**



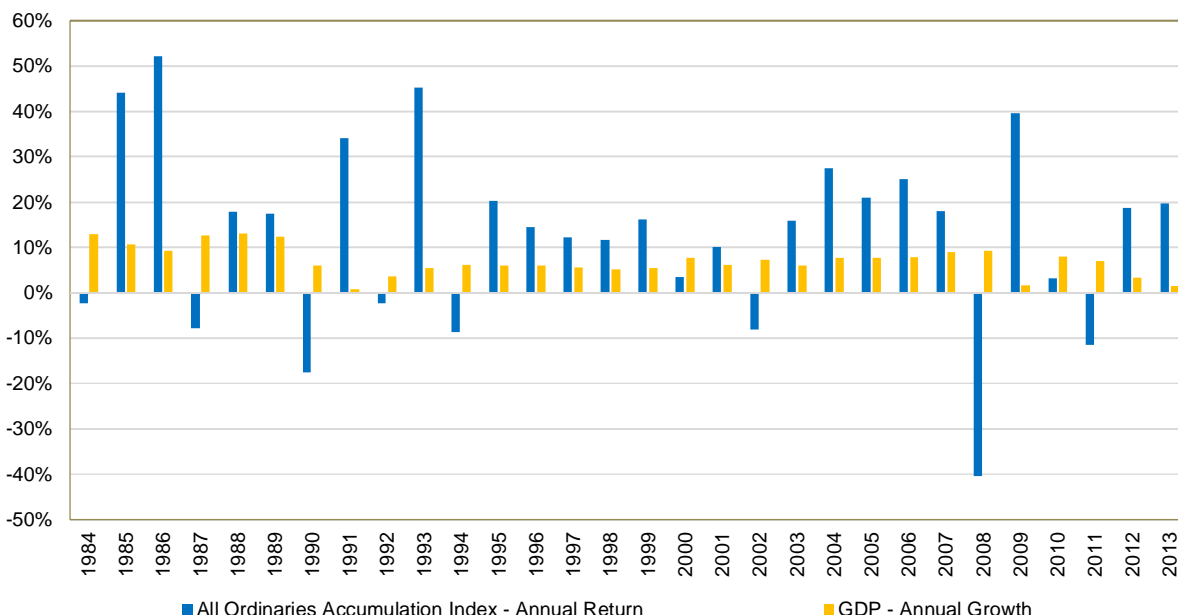
**The Attraction Of Having Surplus Capital**

Some funds in the market are mandated such that they are fully invested most of the time, with little ability to hold significant cash reserves. The most common arguments that we have heard as to why funds should be fully invested are that fund managers are paid to invest in equities, and therefore they should put the money to work, and that it is not the manager's role to determine capital allocation, which has already been done by the person, company, trust or institution investing in the Fund.

From our perspective the investment manager's responsibility is to maximise the returns generated from equities as an asset class. At times, plentiful opportunities abound to buy parts of quality businesses at cheap prices and managers should be fully invested. This is in contrast to periods when the entire market may look overpriced. Fund managers who are paid to recognise stocks which represent good value should not be precluded from selling stocks when they see them trading at expensive prices. At times it may make sense to hold significant levels of cash. We believe that holding significant levels of cash provides the fund manager with the best opportunities to generate excess returns, because the manager is then in a position to take full advantage of compelling opportunities as and when they arise.

The market and its constituent stocks do not trend exactly in line with their underlying fundamentals. There are times when the market gets overly excited about the prospects for revenue and earnings growth. At other times the market becomes overly bearish about this outlook. Over time this results in the market and stocks overshooting what we would consider to be their real value in both directions. This is somewhat reflected in the graph below which plots the annual returns of the All Ordinaries Accumulation Index against GDP growth over the last 30 years. Clearly the growth in GDP, a significant underlying fundamental driver of stockmarket returns over time, is not consistently reflected in asset prices. Indeed the variance of annual returns on the All Ordinaries Accumulation Index over the period shown is 22.0%, compared to just 3.2% for GDP growth.

**All Ordinaries Accumulation Index / GDP - Annual Growth**



This variance creates opportunities for fund managers, as long as they are in a position where they can sell stocks when they appear expensive and buy stocks when they appear cheap. Indeed the pronounced moves in the market are why we generally aim to have sufficient capital at work to generate meaningful returns, while leaving ourselves with surplus funds to take full advantage of opportunities. Our aim is to manage money in a way that maximises the potential to generate compounding returns over time. Our view is that a long short fund managed in the way we have described affords us the best chance of doing so.

***If you do not currently receive the Auscap Newsletter automatically, we invite you to register.*** To register please go to [www.auscapam.com/](http://www.auscapam.com/) and follow the registration link.

Interested wholesale investors are encouraged to download a copy of the Information Memorandum from the website, [www.auscapam.com/information-memorandum](http://www.auscapam.com/information-memorandum).

We welcome any feedback or comments you have. Please direct them to [info@auscapam.com](mailto:info@auscapam.com).

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