Why Auscap Asset Management is 50 per cent cash

Auscap's Matthew Parker, left, and Tim Carleton have found few compelling opportunities following the market shakeout. Michel O'Sullivan

by **Kate Cowling**

Many Australian equities fund managers have had woeful returns in last 12 months, with mining and the big banks facing significant challenges. Auscap Asset Management has been a rare exception.

Run by Tim Carleton and Matthew Parker, both formerly of Goldman Sachs, the three-year-old fund has returned 21.94 per cent in the year to April 1.

Carleton and Parker describe themselves as both value and long/short managers, saying the market conditions they have seen since the fund's launch has suited them perfectly.

However, at the moment, they have got more than half the fund in cash due to a lack of opportunities in the Australian market.

"If we think about the stocks that dominate the bourse from a market cap perspective, most of those companies are facing significant earnings pressure," Carlton says.

By steering clear of some of the problems at the larger end of town though, they have managed to find some standout sectors.

You've done exceptionally well in the last 12 months. What do you attribute that to?

Tim: You always have to be aware of when the market's favourable for you. In the last year it's been a really good market for long/short strategies. We were exposed to growing businesses on the one hand and able to be short some of the sectors that were doing poorly. Our longs performed well for the fund and our shorts also performed well for the fund. It gave our investors a return above what we would normally expect.

What are your fundamental investment rules?

Tim: We suspect many investors are focused on finding the fastest-growing companies, the prospective 10 baggers. We're trying to find lower risk investments that have an adequate return on capital. They're the steady earners with low earning volatility that grow gradually over time. Often they're underpriced because a lot of people are looking for stocks that might generate 20 per cent-plus returns per annum. If we can find a company with a 6-8 per cent earnings yield and those earnings are growing at 3-6 per cent per annum, we think those total return metrics are quite attractive. So if we can find companies where we think the total return payoff is in the 10-15 per cent range per annum and they offer those returns with relatively low risk compared to the alternative, they are the sort of investments we get attracted to.

What have the opportunities been like recently?

Matt: We typically might find five to 15 compelling opportunities a year. The opportunities come about when a company we like trades at a price we find attractive. This might happen because the stock price reacts to shifts in short-term consumer sentiment, or a government announcement affects perception around a sector, or the currency moves and investors overreact. These type of events might mean that you get an opportunity to buy a handful of great companies at prices that we find to be good value. It doesn't happen very often so the vast majority of the time we try to be patient and sit on the sidelines. A lot of the positions we've held for the last couple of years got to the point at the back end of last year where they exceeded our estimate of fair value. We started reducing the positions and some of them we exited entirely. We haven't in the last three to four months found many compelling investment opportunities.

Under what circumstances do you sell?

Tim: There are two reasons, one is definitely if a stock starts to materially exceed our estimate of fair value. We like all of the stocks in our portfolio to be trading somewhere between cheap and fair value. The second is if we realise we're wrong and that happens with unfortunate regularity. It may be that between 30 and 40 per cent of the time we realise our investment thesis is incorrect. We might have underestimated some of the potential negatives, maybe the earnings growth we anticipated was illusionary. We hope this percentage will go down over time.

What do you make of the lack of opportunities in the market?

Tim: Normally if a market had pulled back in the way our market has we would find a lot. When we analysed this in January we realised that it was a function of the Australian market's concentration. Of the stocks that dominate the bourse from a market capitalisation perspective, most of these companies are facing significant earnings pressure. Over the last year the stocks and sectors that had declined had pulled back for good reason. What surprised us was that our analysis indicated that over 40 per cent of the market delivered a positive total return over the period in which the indices fell more than 20 per cent. So the better performing companies weren't declining with the broader market. This made some sense of why we weren't finding a huge number of new opportunities.

Matt: At the moment we have more than 50 per cent of our assets are in cash. It's not a result of us actively taking a view on the market. We rarely take a view on the direction of the market. Our positioning is always a function of the opportunity set. At the moment from our perspective, we haven't found any compelling investment opportunities to replace the stocks that we let go. If we can't do that, we simply sit in cash and wait until those opportunities arise.

Where are you seeing the headwinds and tailwinds at the moment?

Matt: The headwinds have been prominent in the resources space. We expect the mining companies and energy companies will continue to face pressure over the next few years. Then more recently the financial institutions are facing a slower growth environment and are being required to improve their capital ratios. Again we think this is likely to continue. The supermarket sector has suffered from increased competition, so margins are under pressure.

Finally it appears Optus and Vodafone have got a bit of their mojo back lately and are competing actively on price, which will likely flow through to profitability. By the same token there are sectors that are doing really well. Domestic tourism, education – especially where providers can attract international students – many of the retailers, those businesses involved in the export of food products, healthcare and nutrition are a few examples.

Do you think the worst is over for mining?

Tim: We think it's very unlikely that you'll get continued growth in demand out of China. If you have demand in China going backwards, which is a strong possibility, it's likely you'll see both prices and volumes fall domestically, so that may be a second wave of pressure for the resource companies and the industries supporting them.