Auscap Long Short Australian Equities Fund Newsletter – August 2014

Welcome

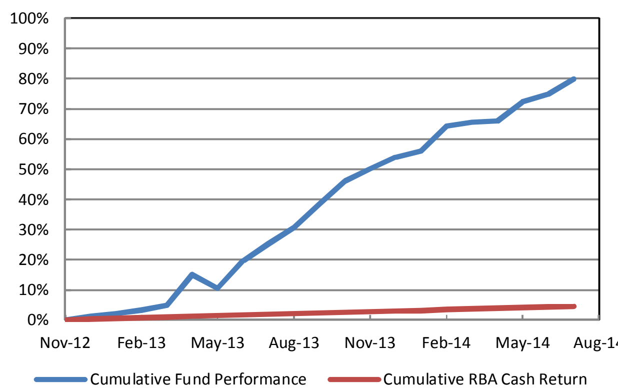
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we provide our view on the perennial question of whether now is a good time to buy equities. We look at this in the context of historical returns delivered by the Australian stockmarket when invested continuously for a significant period of time.

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. Enquiries can be directed to info@auscapam.com.

Fund Performance

The Fund returned 2.95% net of fees during July 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 149.8% long and 26.1% short. Average net exposure over the month was +123.7%. At the end of the month the Fund had 36 long positions and 5 short positions. The Fund's biggest stock exposures at month end were spread across the consumer discretionary, telecommunications, financials, materials and healthcare sectors.



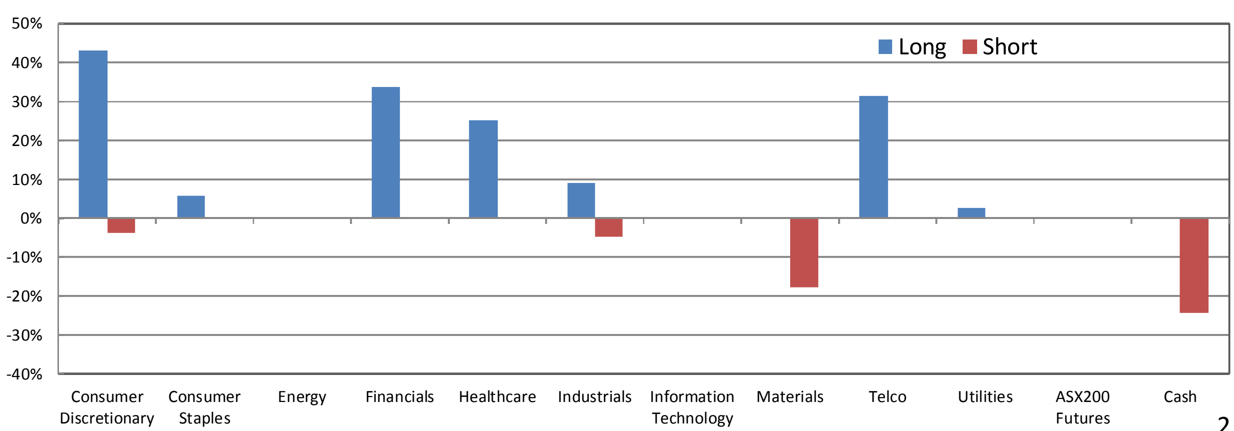
Fund Returns

Period	Auscap	Benchmark
July 2014	2.95%	0.21%
Financial Year to date	2.95%	0.21%
Since inception	79.96%	4.54%

Fund Exposure

July 2014 Average	% NAV	Positions
Gross Long	149.8%	36
Gross Short	26.1%	6
Gross Total	175.9%	42
Net / Beta Adjusted Net	123.7%	81.4%

Sector Exposure - 31 July 2014



Is now a good time to buy equities?

It is the number one question asked of finance professionals. For fund managers it can be a slight variation in the form of ñis now a good time to invest in the fund?ò It might surprise that our answer is that we have no idea. What we can say is that it is normally a good time to invest in equities when there is a high degree of uncertainty, negativity and depressed sentiment in relation to equities as an asset class and when valuations are compellingly cheap. But if youôre in the majority, and worried about financial security when a stockmarket meltdown is occuring, chances are you arenôt thinking about investing more capital at these times.

Conversely, we would suggest that it is generally a bad time to invest in equities when the market is full of euphoria, sentiment is extremely bullish, the economic outlook is positive and valuations are stretched from pricing in those rosy prospects. These are points of maximum participation in the equity market and often offer the lowest potential returns to new investors. It is easy to talk about extremes but not particularly helpful for the would-be investor who did not buy in the panic and is concerned that buying now is buying at the wrong time. The vast majority of the time the equity market does not appear at either end of the spectrum, and meanders along with bullish and corrective market phases, typified in the call that ñitôs a stock-pickers market!ò

One cannot ever expect to know whether it is the exact right time to enter the stockmarket. We do not know when the market is going to go up or down. We cannot tell you when the stocks that we have positions in are going to go up or down. What we can and do concern ourselves with is the process of investing and managing our risk appropriately. This means not investing when we canôt see value, and investing significantly when we do see value despite what market participants and the media might be saying at any given point. We also evaluate the broad nature of the market in comparison with historical references, with the aim of drawing some broadbrush conclusions about general valuations.

"The idea that a bell rings to signal when investors should get into or out of the stock market is simply not credible. After nearly fifty years in this business, I do not know of anyone who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently."

John C. Bogle
Common Sense on Mutual Funds (1999)
Founder & former CEO, Vanguard Group

Right now the market is trading on a forward price to earnings multiple of between 14 and 15, which is close to the historical average. Unfortunately, the market tends not to stay around the average for long, instead passing through it on its way to becoming relatively expensive or cheap. Added to this is the fact that market circumstances are never identical to past points in history. We can look at the current environment and suggest that the growth outlook is weaker than at many points in the past, but at the same time interest rates are also at historically low levels. What this means for the market in the short term is anyoneôs guess.

We do not try to predict where the market is going. We would suggest that worrying excessively about short term movements is not particularly helpful in generating long term returns, especially if it results in not participating in the stockmarket at all. Over the long term we are positive on equities as an asset class. From our perspective it makes sense for most people to have exposure to equities most of the time as a way of generating real returns (by which we mean nominal returns less inflation). For those investors who donôt have experience in equities, the best exposure is most likely through a managed fund with a strong performance track record.

Why are we broadly positive on equities as an asset class? History suggests that investing in companies that have a proven track record of delivering sustainable and growing returns on equity over time will increase wealth. If, as an investor, you have a sufficiently lengthy time horizon, your investment in equities should, pardon the pun, pay dividends over the long term.

The performance of the All Ordinaries Accumulation Index over the last one hundred years suggests that an investment in the broadest measure of equities for any investor with a long time horizon will generate real returns in excess of the returns offered by cash products, the liquid alternative for most investors. We have gone through the last hundred years of data and put together a number of charts that look at investor returns if one had invested at the start of any given year and held the All Ordinaries Accumulation Index for 20 years.

We have done this to focus on the variance of returns delivered to investors at the end of 20 years, whether they invested at the best or worst possible times. If you were invested in the All Ordinaries Accumulation Index for any 20 year period from 1914, the average nominal return was 13.0% per annum, which equates to a 1057% return over 20 years (thatœs 10.6x your initial investment!). The median return was 12.7% per annum, or 988% over 20 years. The highest return offered was 18.1% per annum, if you were lucky enough to invest at the start of 1975 after the market meltdown of 1973-74. Perhaps more significantly, the lowest 20 year return was 8.9% per annum, or 446% over 20 years, if you invested in 1992 and therefore suffered from four market corrections over 20 years, including the dotcom crash of 2002, the global financial crisis of 2008 and the market corrections of 1994 and 2011. The analysis does not include any investment period starting post 1994, since there is not 20 years of data for these periods.

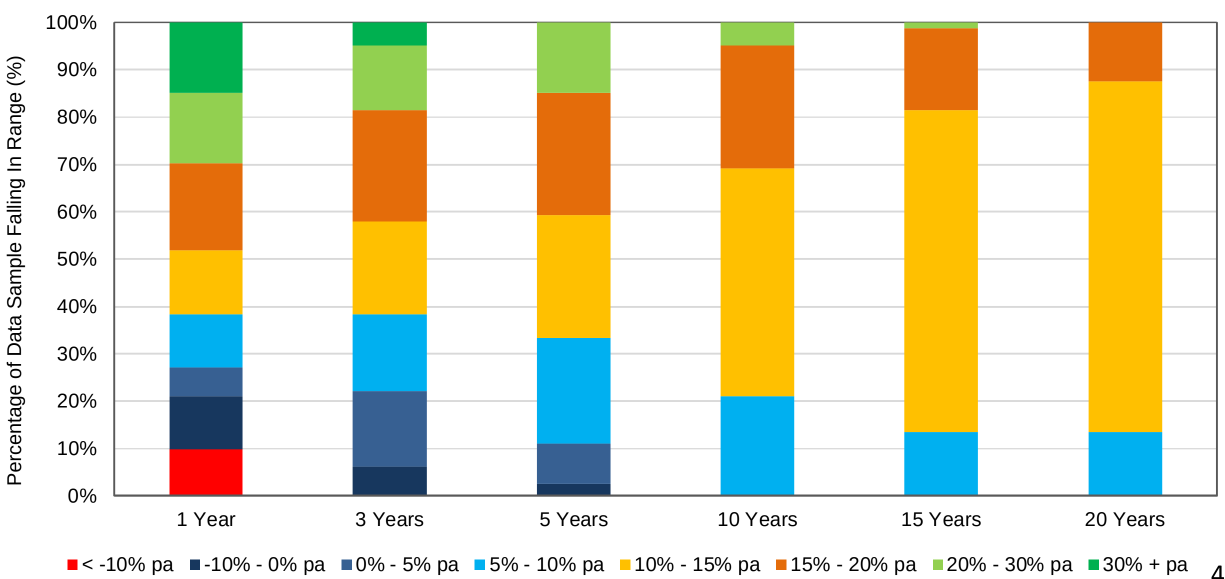
All Ordinaries Accumulation Index 20 year returns: 1914-1993*

	Return pa	20 Year Return
Mean	13.0%	1057%
Median	12.7%	988%
High	18.1%	2687%
Low	8.9%	446%

* AMP, Bloomberg

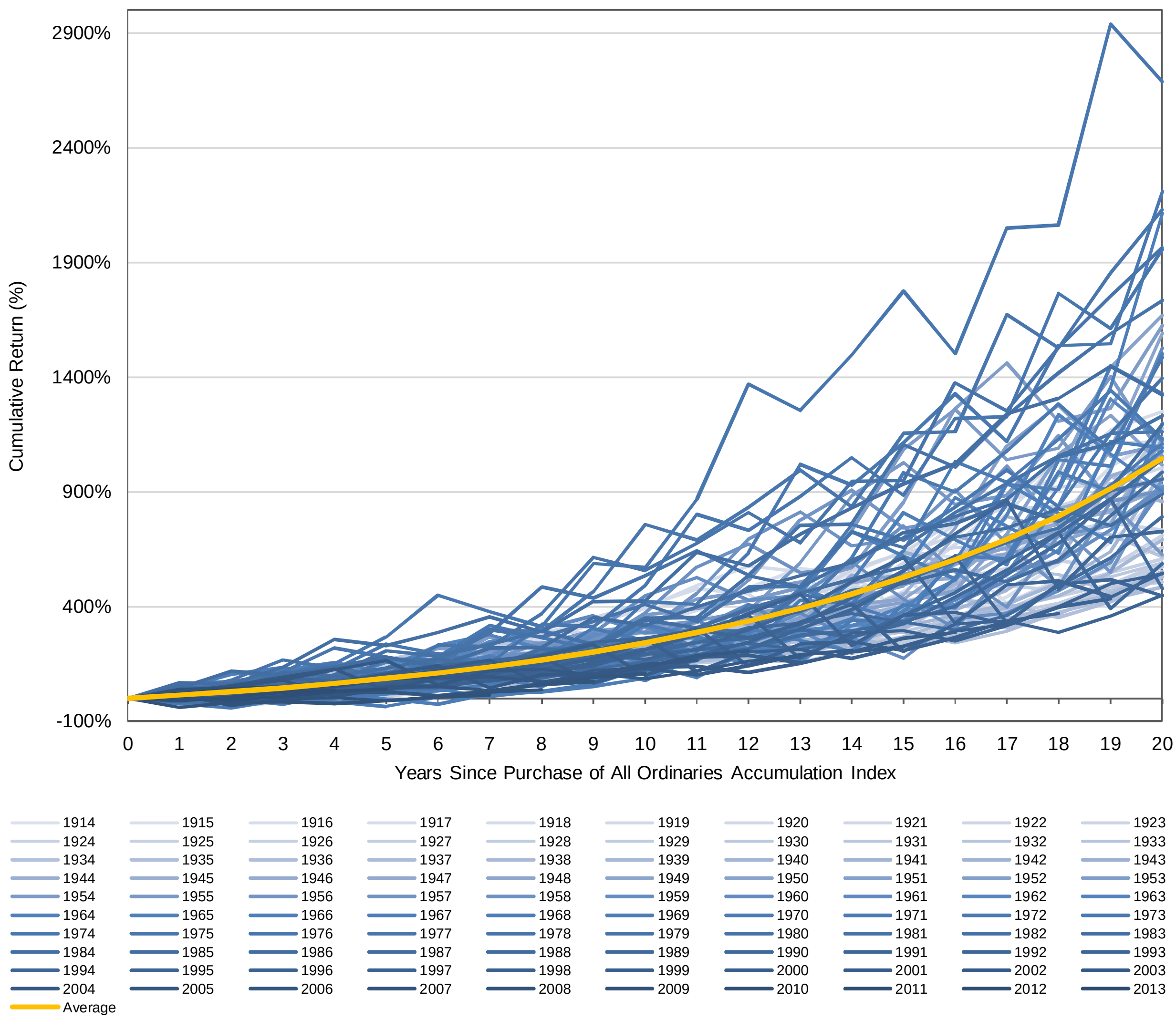
Over the short term, fortunate timing of the market might be advantageous, but for those investors with a sufficiently long time horizon, the data converges over 20 years, as shown in the chart below. In other words, if your time horizon is sufficiently long and you are confident that you wonœt have to exit your investment in the darkest hours, your returns will normalise over time. Investing in the All Ordinaries Accumulation Index at the start of any calendar year between 1914 and 1993 would have an annualised return of between 8.9% pa and 18.1% pa over 20 years. By comparison, the best and worst returns on a 1 year time horizon during this period were 55.8% and ï 28.1% respectively.

All Ordinaries Accumulation Index
Annualised performance over select time periods from 1914-1993



The performance of an investment at the start of any calendar year from 1914 to 2013 for a maximum of 20 years is represented in the chart below. It is an alternative way of showing the convergence of results on an annualised basis as the length of time increases.

All Ordinaries Accumulation Index
Cumulative Returns For Investments Commencing 1914-2013

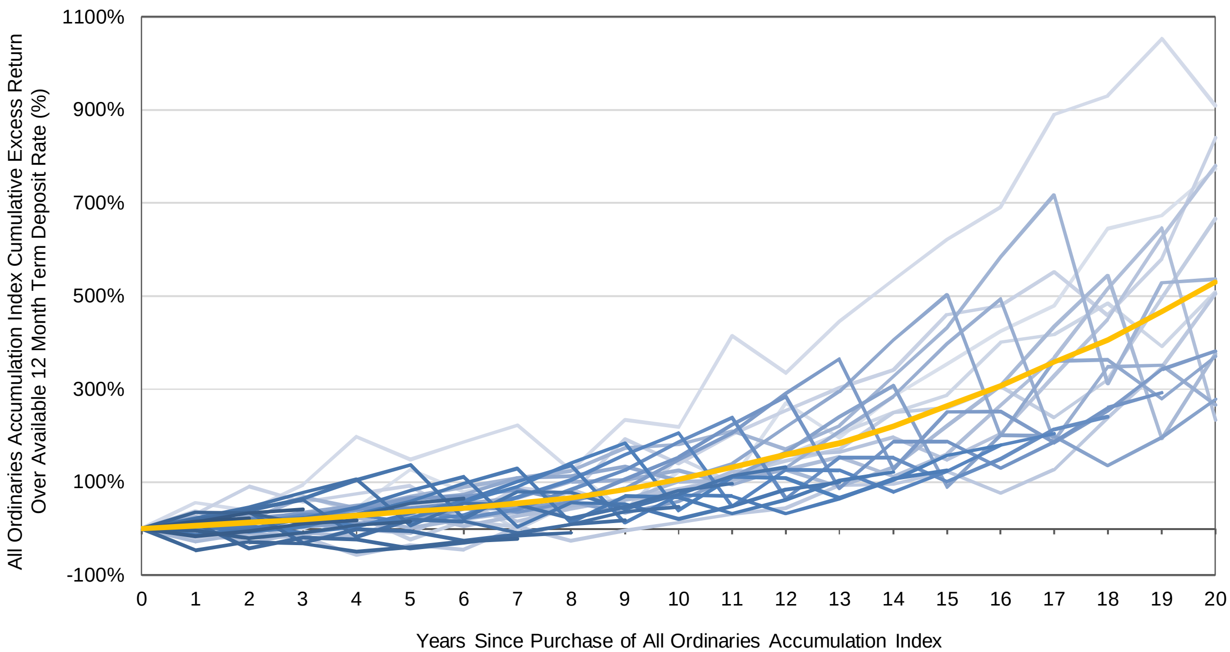


We would note that this analysis does not consider the negative effects of taxation, and assumes compounding of pre-tax returns. The analysis does also not consider any benefits associated with the franking credits that have been attached to dividends paid by listed companies.

It is important to put this performance in context. In particular, how do these returns compare to the (almost) risk free alternative of term deposits with the major banks? And how does the performance of equities appear when it is inflation adjusted? This is important because some results may be distorted given periods of strong inflation and/or high interest rates. The comparison with cash returns is useful because any results are likely to understate the benefit of an investment in shares given the preferable treatment of franking credits attached to dividend income and the capital gain taxation discount available for shares held for more than 12 months that are not available for interest income.

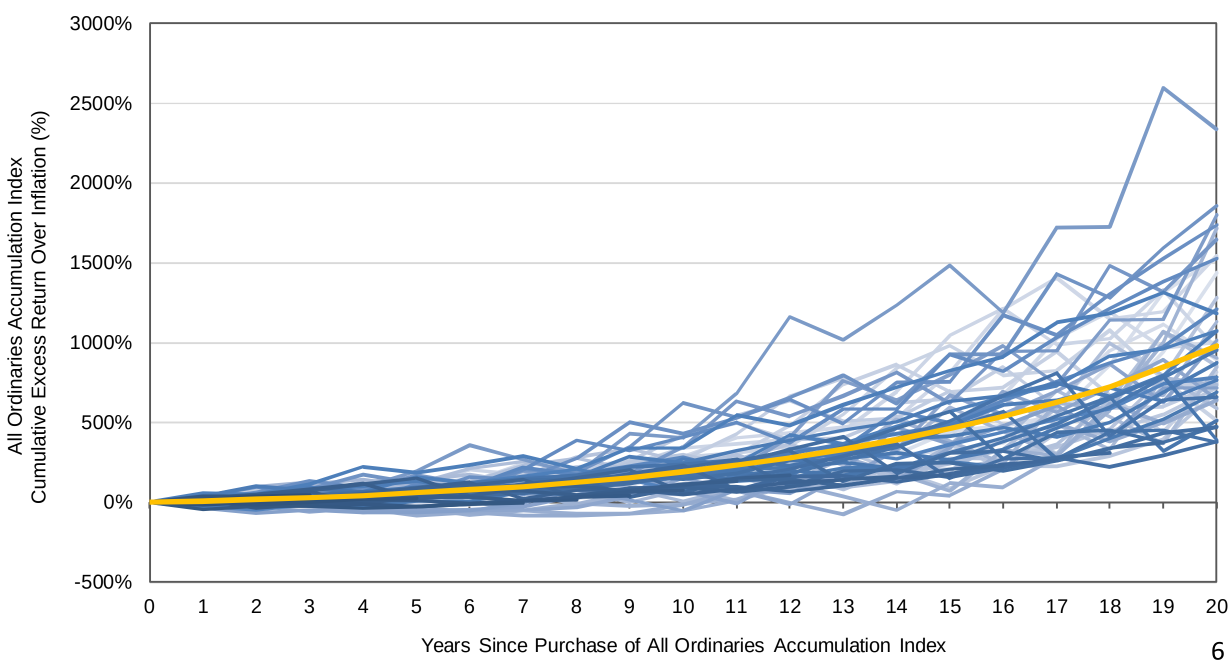
An investment in the All Ordinaries Accumulation Index has, over the period of the available data set, done materially better over any holding period of 10 years or more than a rolling investment in a 12 month term deposit (based on the deposit rate information provided by the RBA for the period 1982-2013).

All Ordinaries Accumulation Index Returns Less Term Deposit Rates 1982-2013



The data also suggests that shares provide a positive real return over time. To date, the longest period it has taken equities to generate a positive real return was 15 years if one had invested at the start of 1969 and remained invested over the high inflation period of the 1970s.

All Ordinaries Accumulation Index Returns Less Inflation 1949-2013



Most of the time markets are not excessively expensive or ridiculously cheap. History suggests that worrying about short term market movements might prevent an investor from making significant real returns over the medium to long term. If you are not an equities specialist, and donꞌt wish to invest in an index tracking product, then it is important to find a manager with a strong performance track record who invests in a manner that you are comfortable with and has an investing time horizon that matches yours. If you can find one that generates meaningful outperformance over the index then the compounding effect of this is very significant. At Auscap we look for companies that represent compelling value to us over the medium to long term, and which are, preferably, worth more to us for every day of ownership because they generate strong cash flows through consistent and growing earnings.

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

We welcome any feedback or comments you have. Please direct them to info@auscapam.com.

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