Auscap Long Short Australian Equities Fund Newsletter – July 2014

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Welcome

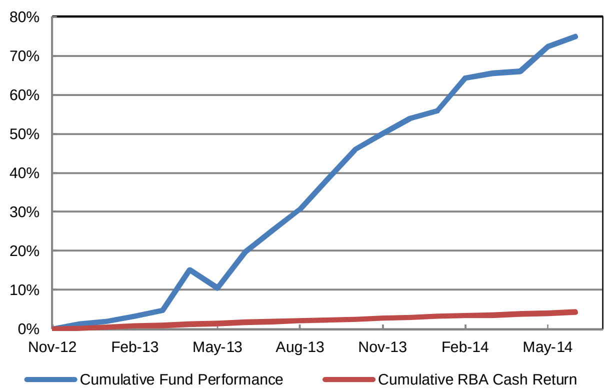
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we reflect on the performance of the Fund over the last financial year from both a returns and volatility perspective, and discuss our future expectations in the context of the broader market.

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 1.48% net of fees during June 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 147.1% long and 31.7% short. Average net exposure over the month was +115.5%. At the end of the month the Fund had 37 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the consumer discretionary, telecommunications, financials, materials and healthcare sectors.



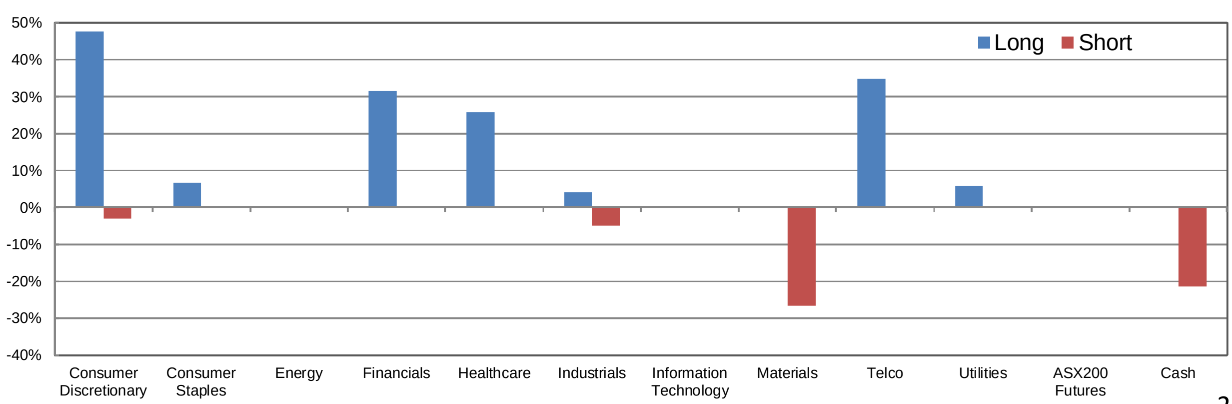
Fund Returns

Period	Auscap	Benchmark
June 2014	1.48%	0.21%
Financial Year to date	46.01%	2.55%
Since inception	74.80%	4.32%

Fund Exposure

June 2014 Average	% NAV	Positions
Gross Long	147.1%	37
Gross Short	31.7%	9
Gross Total	178.8%	46
Net / Beta Adjusted Net	115.5%	67.4%

Sector Exposure - 30 June 2014



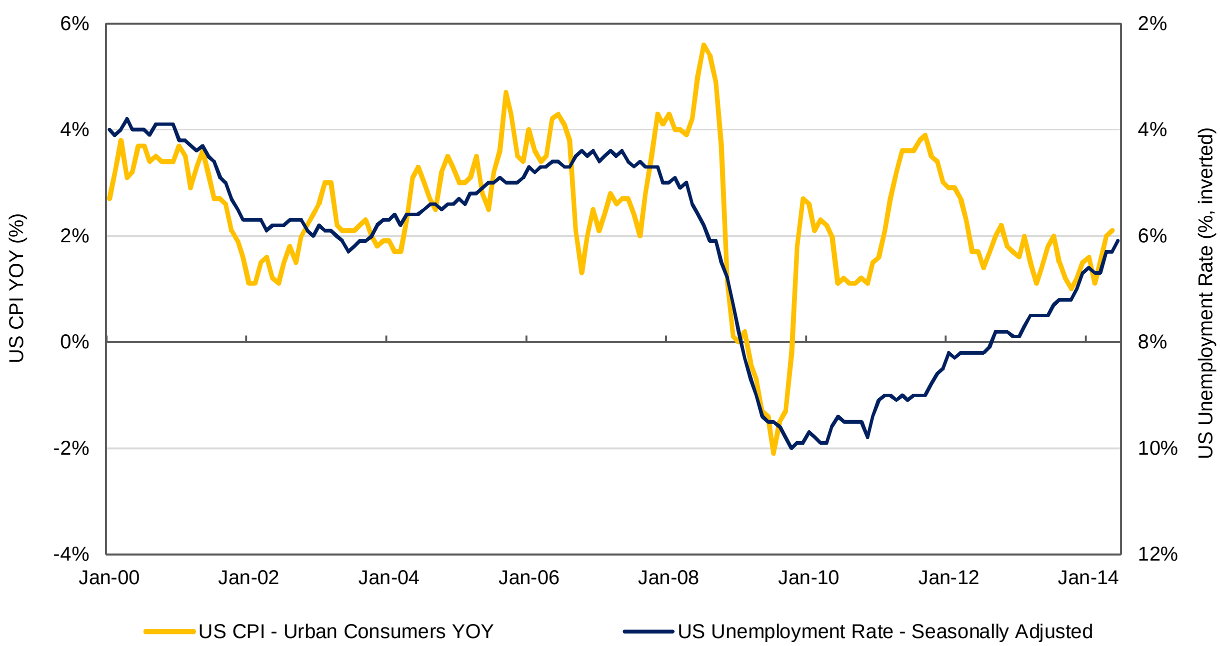
Distinguishing Risk From Volatility

The Auscap Long Short Australian Equities Fund delivered just over 46% for investors in the financial year to 30 June 2014. While we are very pleased with the returns to date, we caution investors that this performance will most likely not be replicated any time soon. The Fund's performance was unusual not only in terms of its strength (the portfolio managers target considerably lower returns when making investment decisions), but even more so for the low volatility exhibited. The Fund had no negative months during the financial year, a scenario that is very unlikely to be repeated. We attribute this feature of the Fund's performance to a number of factors, some of which are beyond any manager's control.

Chance has played a role. Different positions within the Fund have appreciated at different points during the last year. This has more to do with the short term "random walk" of stock prices and market indices than it does managerial skill. While we like to buy at times of negative investor sentiment, we do not try to time our investments and the steady nature of returns has been, to some extent, a function of good luck.

More broadly, the Fund has been a beneficiary of the low volatility recently witnessed across financial markets. Global financial markets are being pumped full of liquidity from central banks in America, Europe and Asia. To some extent this is devaluing currencies and revaluing hard assets. Financial markets are assuming that the United States will continue zero bound interest rates well into 2015 and quantitative easing until October 2014. This is despite an unemployment rate of only 6.1%, down from 10.0% at the height of the Global Financial Crisis, and inflation at 1.8% in the year to the end of May 2014, just below the US Federal Reserve's official target of 2%. While these factors cannot be looked at in isolation, we do find it interesting that expectations have changed so little in light of the better than expected data.

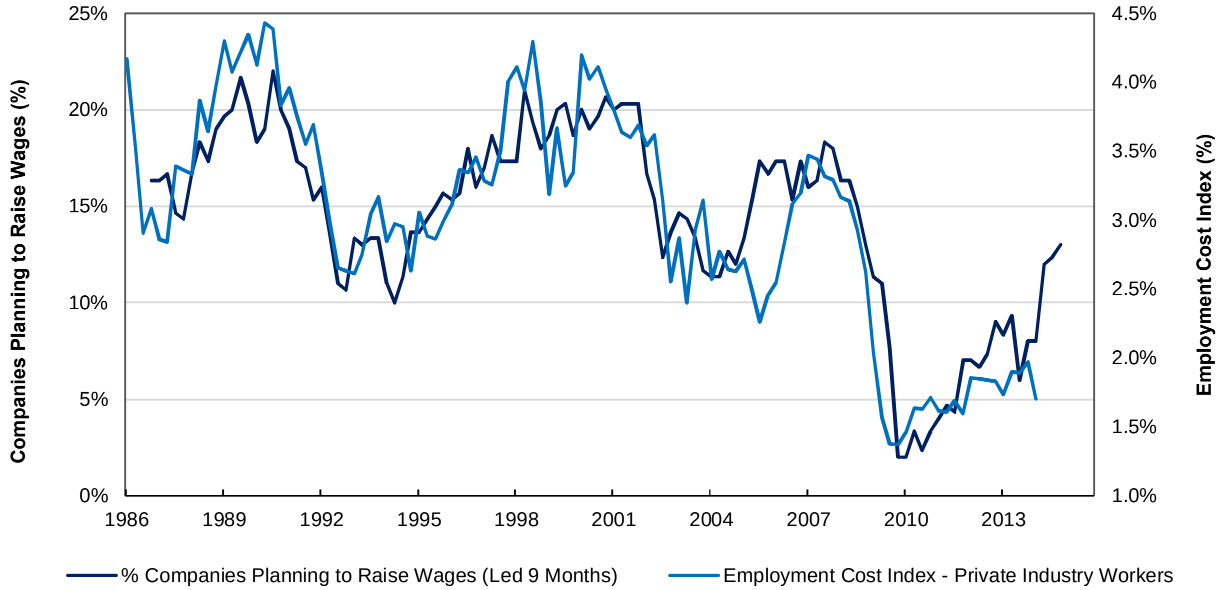
US Inflation and Unemployment



A large part of this stems from the views publicly expressed by the Federal Reserve. In comments made by US Federal Reserve Chair Janet Yellen on 15 July 2014, she noted that while progress has been made towards maximum employment and price stability, the weaker than expected labour force participation rate and slow pace of growth in hourly compensation (wages growth) indicate continued slack in labour markets.

However, corporate expectations in regard to employment costs suggest that wage growth may accelerate in the near term.

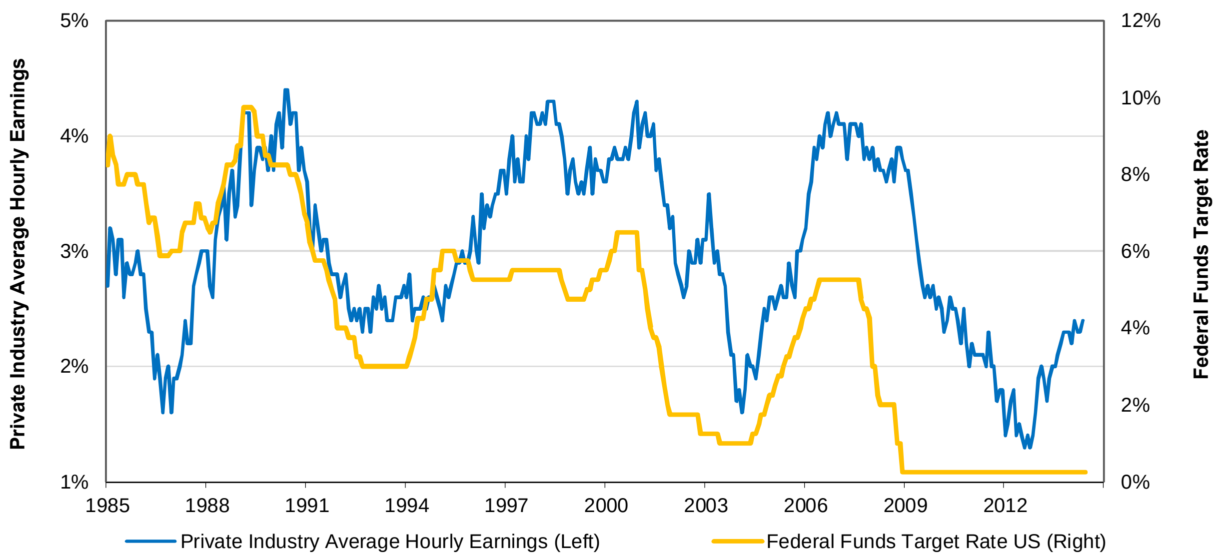
US Wages Growth



Source: Deltec International Group

One might expect that such a development would prompt the Federal Reserve to revise its estimate of when to lift interest rates from the current expectation of a ŗconsiderable period after the asset purchase program endsò

US Average Hourly Earnings vs Federal Funds Rate



Source: Deltec International Group

The continued stimulus has played its part in inflating asset prices and reducing overall market volatility. In fact, with the S&P 500 having gone 1,017 days without a 10% correction, this is currently the USô5th longest bull market without such a correction in the post WW2 period.

Longest Periods for S&P 500 Without a 10% Correction

Rally Start	Rally End	Rally Length (Days)	% Gain
Oct 11, 1990	Oct 7, 1997	2,553	232.7%
Mar 11, 2003	Sep 22, 2006	1,291	64.2%
Oct 23, 1962	Feb 9, 1966	1,205	75.8%
July 24, 1984	Aug 25, 1987	1,127	127.8%
Oct 3, 2011	TBD	1,017*	79.5%

* 1,017 days as of 15/7/2014
Source: RBC Wealth Management, Auscap

The US market has also been unusually benign, with volatility at levels not seen since 2006. The VIX index measures volatility in the value of the S&P500 Index, the most frequently used index to reference the performance of the US stock market. Indeed it has now been 62 days since the market has had a daily move of more than 1%, the longest such period since 1995 when the market went 95 days without such a move. This low volatility has been mirrored in the Australian and other financial markets.

These features of the market are no doubt reducing the volatility of monthly returns seen by both Auscap and other managers in recent times. We do not expect that the Fund's future returns will have the exceptionally low volatility seen in the recent past. While we anticipate higher volatility, we would also reassure investors that our process for identifying opportunities and investing the Fund's assets will remain exactly as it has been.

We would also distinguish between volatility and risk. Volatility is how prices move up and down over time. By contrast, we look at risk in terms of the potential for permanent loss of capital. Our investors should rest assured that we have low tolerance for this type of risk. To us, minimising the risk of permanent loss of capital is at the heart of our value approach to investing. In a low volatility environment we believe it is important to be especially prudent. Low volatility can *often* accompany periods where asset prices are high and hence we might be better placed reducing our exposure to equities. We try to focus on this fact when markets are calm and returns are strong. We would add that this does not imply that we have concluded that equities are currently expensive just because volatility is low. The opposite is also true. Times of great volatility often present the best opportunities for low risk long term investing. Worrying about short term volatility in performance during periods of great opportunity would be contrary to the long term interests of investors in the Fund.

In the short term, any fund's return profile is, to a large extent, dictated by the course of the market. Over the medium term we believe that finding companies to invest in that meet our risk and return profile will determine the Fund's results. Unusual times do not require a unique methodology and we will continue to assess each opportunity for investment in absolute terms.

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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