Auscap Long Short Australian Equities Fund Newsletter – May 2014

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Auscap
Asset Management

Welcome

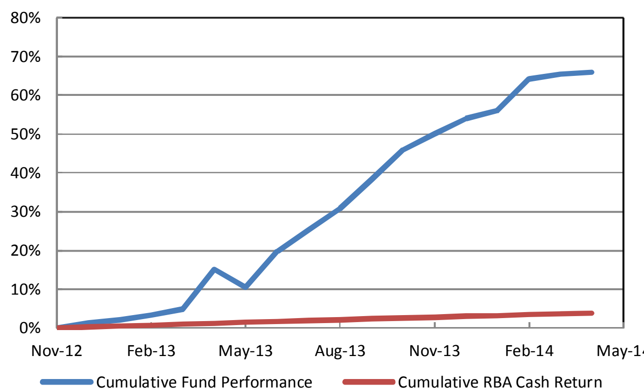
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (ĩFundõ) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we take a look at the Australian Federal Budget and compare the measures proposed in the Budget against those implemented by the Coalition in the contractionary Budget of 1996, focusing on the potential short term impact on discretionary retail performance.

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 Fundõs Information Memorandum, is available at our website www.auscapam.com. Enquiries can be directed to info@auscapam.com.

Fund Performance

The Fund returned 0.29% net of fees during April 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 123.9% long and 24.5% short. Average net exposure over the month was +99.4%. At the end of the month the Fund had 35 long positions and 7 short positions. The Fundõs biggest stock exposures at month end were spread across the consumer discretionary, financials and telecommunications sectors.



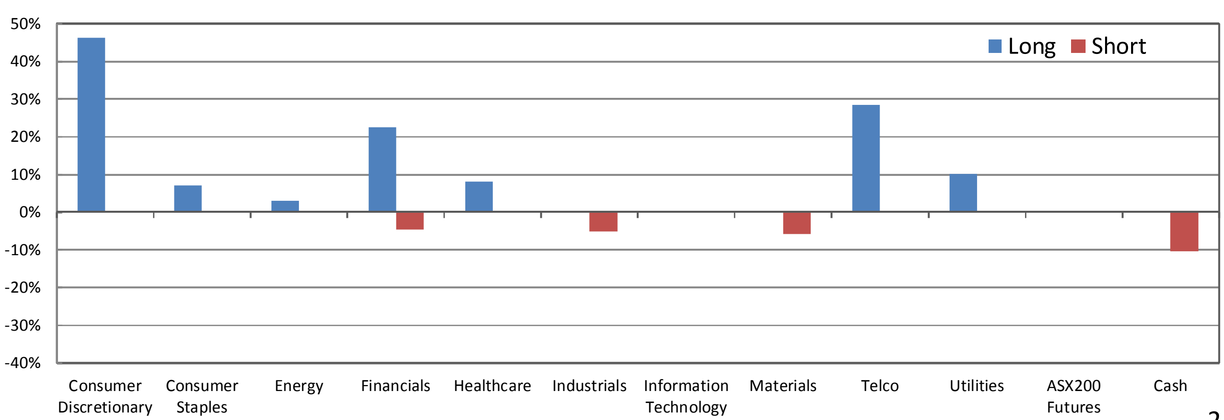
Fund Returns

Period	Auscap	Benchmark
April 2014	0.29%	0.21%
Financial Year to date	38.59%	2.13%
Since inception	65.92%	3.89%

Fund Exposure

April 2014 Average	% NAV	Positions
Gross Long	123.9%	36
Gross Short	24.5%	6
Gross Total	148.4%	42
Net / Beta Adjusted Net	99.4%	69.6%

Sector Exposure - 30 April 2014



Australian Federal Government Budget 2014 – Historical Indications As To The Potential Effect On Discretionary Spend

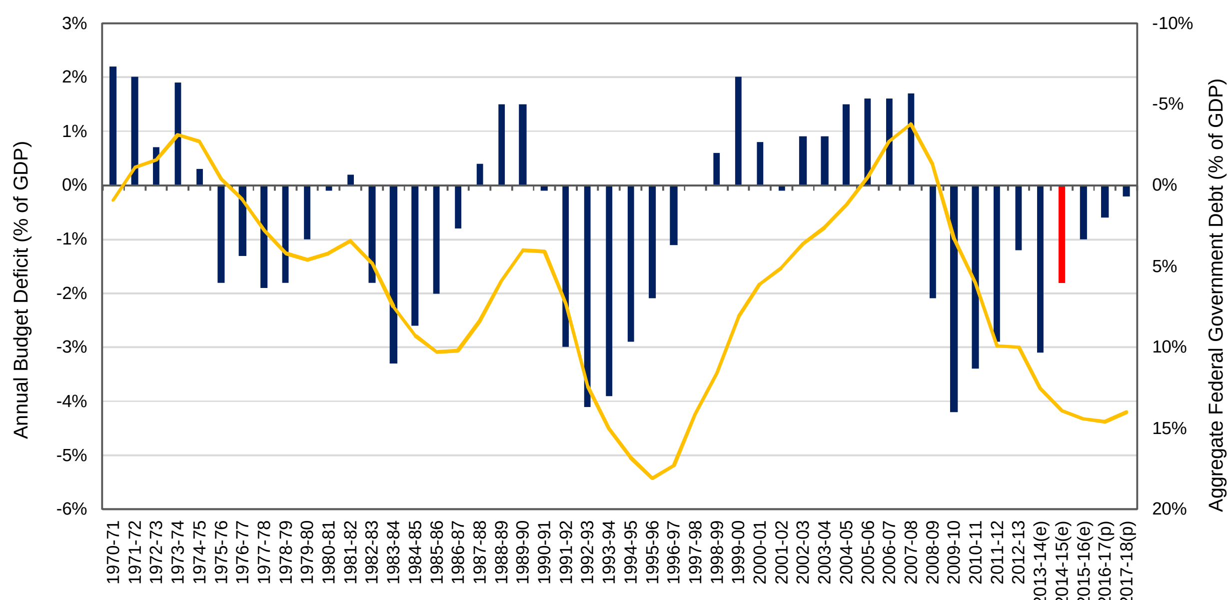
ñTonight I announce a program é to repair the nationôs finances and secure our future. This Budget implements the key election commitments of the Coalition and it does so as part of a responsible economic strategy. The focus is savings ï savings for investment, sustainable growth and real jobsò the Treasurer began.

ñIf we took no corrective measuresé we would still have an underlying deficit of 2 per cent of GDP even though the economy has had five years of growth. Debts would be increasing and Australia would be dangerously exposed to shifts in the international outlook or sentiment. In periods of growth we must put away savings for the downturns. But far from saving, the previous Government kept ratcheting up our debts ï spending money it didnôt have.ò

You could be forgiven for thinking that these were the words of current Federal Treasurer, Joe Hockey, presenting the Budget in 2014. While the tone of the speech strongly reflects the current political situation and fiscal outlook, it is in fact the start of the speech by former Treasurer, Peter Costello, presenting his first Budget on the 20th of August 1996.

Indeed, the state of the Budget today is not that dissimilar to what it was back in 1996. Annual deficits as a percentage of GDP had been in excess of 2% of GDP for 4 years and the Coalition had stormed to victory determined to fix the fiscal position of the nation. Aggregate Federal Government debt stood at $95.8bn at the end of FY96, equivalent to 18.1% of GDP. This compares to the $197.9bn of debt forecast for the end of FY14, representing 12.5% of GDP. Unlike in 1996, though, the aggregate Federal Government debt is currently expected to continue to rise, peaking at 14.6% of GDP in FY17.

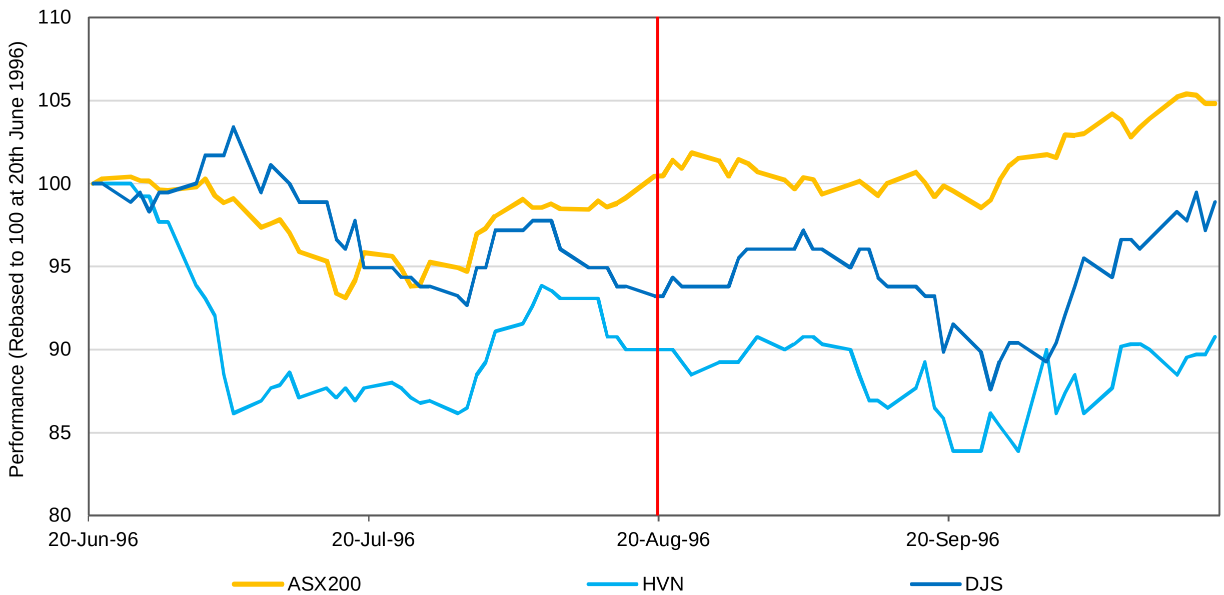
Australian Federal Government Budget Deficits and Aggregate Net Debt



Source: Australian Federal Government, www.Budget.gov.au

Then, as now, sentiment was largely negative and consumers were cautious. This was reflected in the performance of the discretionary retailers, who underperformed in the lead up to and immediately following the Budget. By way of example, the stock prices of Harvey Norman and David Jones, which were both listed at the time and still are today, are plotted below against the performance of the All Ordinaries Index.

Select Retail Stocks vs ASX200 - Pre & Post 1996 Budget



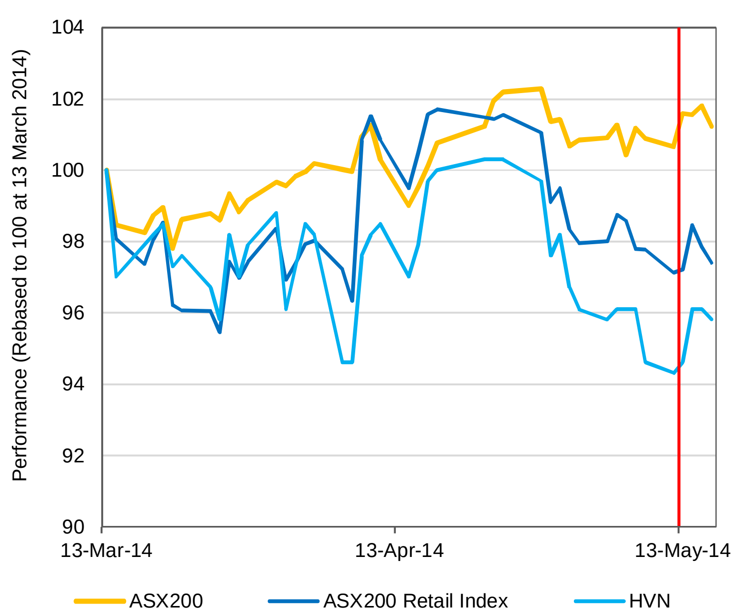
This stock performance has been very similar to the trajectory of the major retail stocks in the eight weeks leading up to the 2014 Federal Budget, with the sector significantly underperforming the market. Investors have been concerned about the implications for retail spend of measures that were leaked before, and then officially announced at, the Budget.

It should be noted that not all of the poor performance in the major retail stocks can be attributed to Budget fears. Most companies reported 3rd quarter sales in the same pre-Budget period, and the performance of the stocks for companies that have significantly surpassed or fallen short of expectations are more likely attributable to issues specific to that company than sector wide concerns.

However it seems highly likely that given the significant underperformance of the sector as a whole against the broader market, fears around the Budget may have had some effect on prices in the sector.

In the 1996 Budget there were significant measures put into place to rein in spending. A number of experienced commentators have suggested that in fact the 2014 Budget will have materially less impact on consumer discretionary spend than the 1996 Budget. Below we compare the 1996 Budget tightening measures to the 2014 measures.

Retail vs ASX200 - Pre 2014 Budget

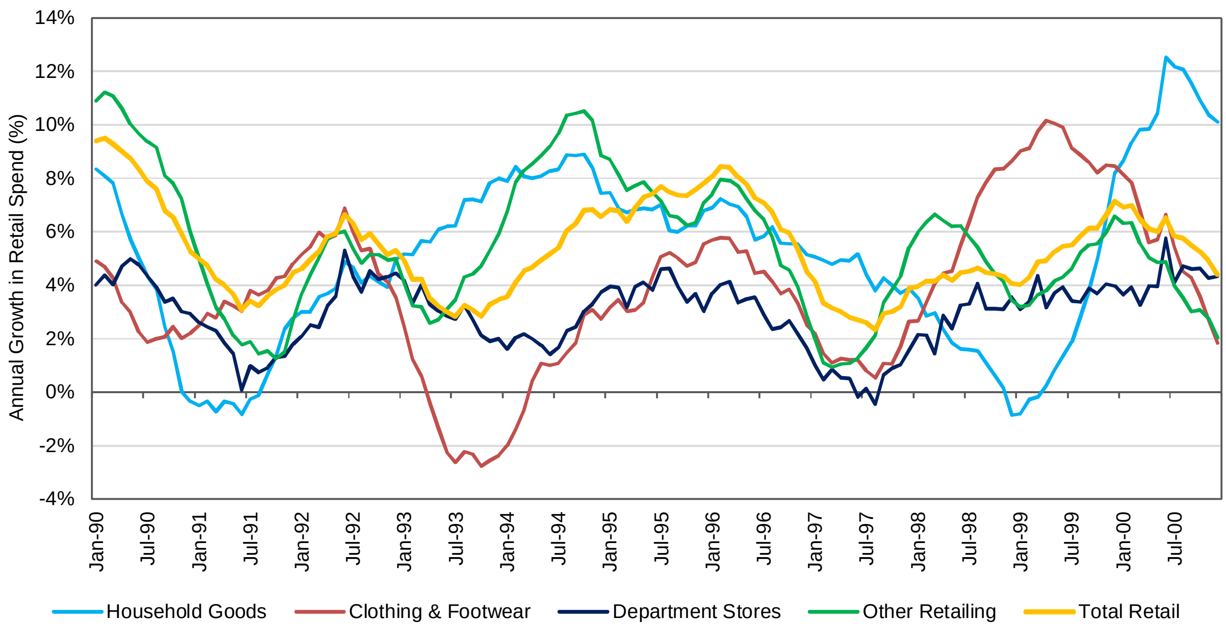


"Compared with the mid 1996 tightening that contributed to a decade of fiscal improvement, the [2014-15] Budget represents barely one third the fiscal tightening as a share of GDP."
Scott Haslem, UBS Australia Chief Economist

Area	1996 Budget Measures	2014 Budget Measures
Taxation	A 1% Medicare levy surcharge for couples with combined incomes over $100,000 (individuals over $50,000) who don't take out health insurance from 1 July 1997; compliance measures to improve taxation collection	Budget repair levy of 2% for high income earners over $180,000 from 1 July 2014 for three years
Family Benefits	Introduction of the Government's Family Tax Initiative to provide tax relief via an increase in the income tax free threshold based on the age and number of children in a family	Family Tax Benefit Part A will start to reduce when family income exceeds $94,316; Family Tax Benefit Part B threshold will be reduced to $100,000 and no longer available after youngest child turns 6; Dependent Spouse Tax Offset to be abolished from 1 July 2014
Apprentices	$207m over 4 years for the Modern Australian Apprenticeship and Traineeship Scheme	Concessional trade support loans of up to $20,000 over four-year apprenticeships
Unemployment Benefits	A reduction of the Job Search and Newstart Allowances to save $2.6bn over 4 years; strengthening of the activity test for eligibility for Job Search and Newstart Allowances	Unemployed under 25 to get Youth Allowance instead of Newstart; people under 30 to wait 6 months before getting the dole and required to participate in Work for the Dole
Superannuation	A 15% surcharge on future employer superannuation contributions for those who had income above $85,000, phased in from income of $70,000	Slight delay to the increase in superannuation rate increases
Education	Increase in higher education research scholarships	$820m to expand access to higher education; Universities to set their own tuition fees, fees repayable after students earn over $50,000; reduction in growth in state funding for education
Health	Capping the maximum co-payment for patients under the Pharmaceutical Benefits Scheme; reducing the growth of outlays on diagnostic imaging; and ceasing funding for the Commonwealth Dental Programme, saving in aggregate $1.49bn over four years	Co-contribution for GP visits to start in July 2015 to fund a Medical Research Future Fund; changes to the Pharmaceutical Benefits Scheme; reduction in growth in public hospital funding
Transport & Infrastructure	Budget funding of $75m per annum for National Highways and Roads of National Importance	Fuel excise indexation re-introduced from 1 August 2014; infrastructure growth package of $11.6bn announced to take Government Investment to $50bn by the end of the decade
Government Spending	A large number of Government services and programmes abolished; Government spending on the delivery of its programmes reduced, saving $727m over 4 years	Public service jobs reduced by 16,500 over 3 years; 230 bureaucratic programs and 70 government bodies abolished; MP and public service salaries frozen
Business	Small business capital gains tax rollover relief	Industry assistance programs abolished to save $845m; reduction in the corporate tax rate to 28.5% for small businesses

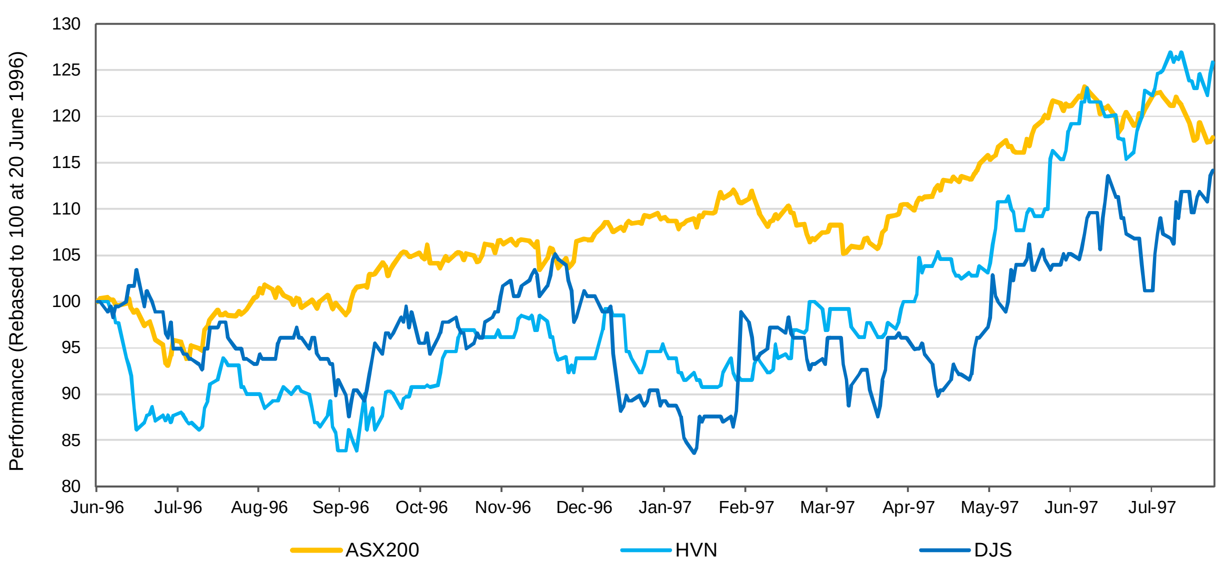
There is no doubt that the 1996 Budget had some impact on consumer spend. As shown below, growth in retail spend certainly slowed in the period following the implementation of the 1996 Budget measures, largely introduced from 1 July 1997. It is less clear how much of this slowdown can be attributed to the Budget and how much was due to the normal cyclicality of retail spend. However, it is worth noting that growth in retail spend was still positive in absolute terms during this entire period, even by sub-sector with the exception of a brief period of negative year on year sales for department stores.

Annual Growth in Aggregate Retail Spend - 1990 to 2000



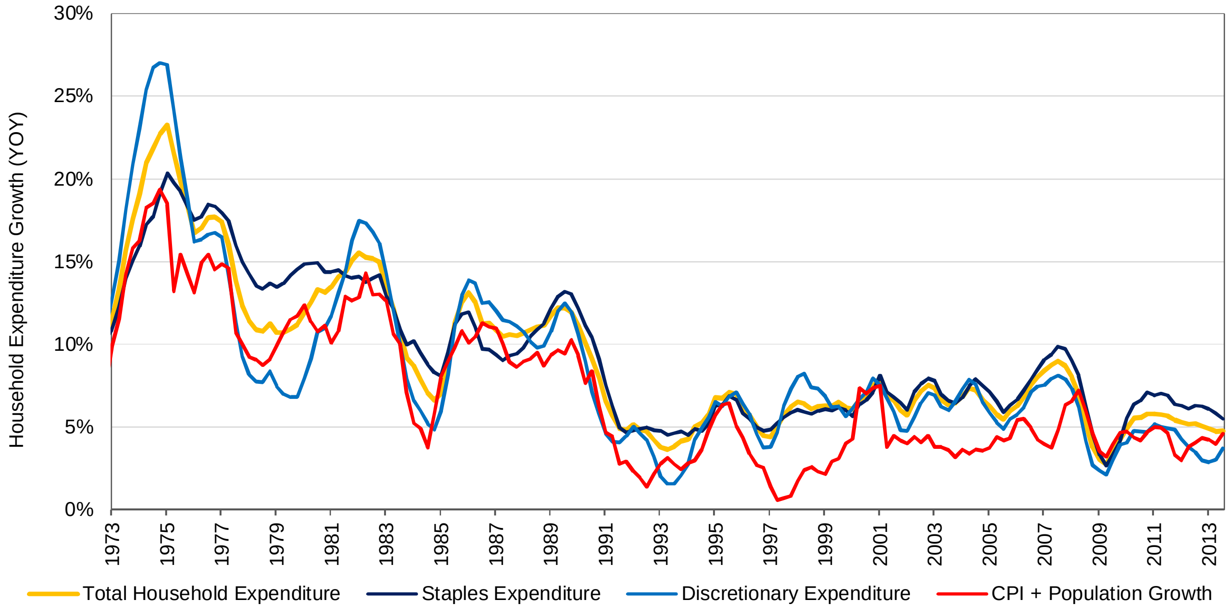
While stocks exposed to consumer spend underperformed in the lead up to and shortly after the 1996 Budget, their underperformance was somewhat reversed in the following 12 months as the market realised the impact on earnings was not as significant as initially expected.

Select Retail Stocks vs ASX200 - Pre & Post 1996 Budget



Consumer expenditure over time is primarily driven by inflation and population growth, in other words the cost of the goods consumers purchase and the number of people purchasing those goods. While there will be an impact as a result of the changes to Government Expenditure listed above, this impact is possibly overstated by the focus on the Federal Government Budget as a media event. Citi estimate that the hit to households in FY15 will be around $5bn or 0.5% of household disposable income, concluding that it should not materially impact consumer spending.

Household Expenditure Growth



While stocks often display short term price volatility based on factors such as consumer sentiment and the latest news headlines, underlying revenues and earnings are typically far less volatile. In managing our existing holdings, we try to give some context to the actual impact of various events on consumer demand for the products or services companies provide. We prefer to analyse the measurable, rather than rely too heavily on the anecdotal. While price fluctuations can impact short term performance, such volatility can also provide opportunities to buy stocks below our estimate of fair value.

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.