Auscap Long Short Australian Equities Fund Newsletter – January 2014

Welcome

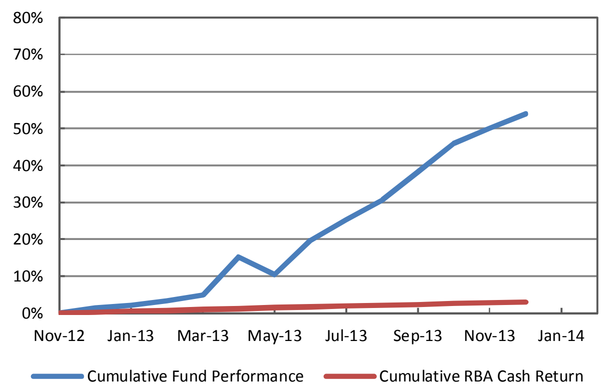
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund (ìFundî) to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. We would like to start by wishing everyone a happy new year and a healthy, enjoyable and prosperous 2014. In this edition we discuss our thoughts on the volatility in December and the opportunities that were presented to investors in a turbulent final month of the calendar year for the Australian 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 Fundís Information Memorandum, is available at our website www.auscapam.com.

Fund Performance

The Fund returned 2.57% net of fees during December, delivering 51.9% for calendar year 2013. The All Ordinaries Accumulation Index rose 19.7% over the year. Average gross capital employed by the Fund over the month was 145.6% long and 26.2% short. Average net exposure over the month was +119.4%. At month end the Fund had 30 long positions and 5 short positions. The Fundís biggest exposures at month end were in the consumer discretionary, financials and telecommunications sectors.



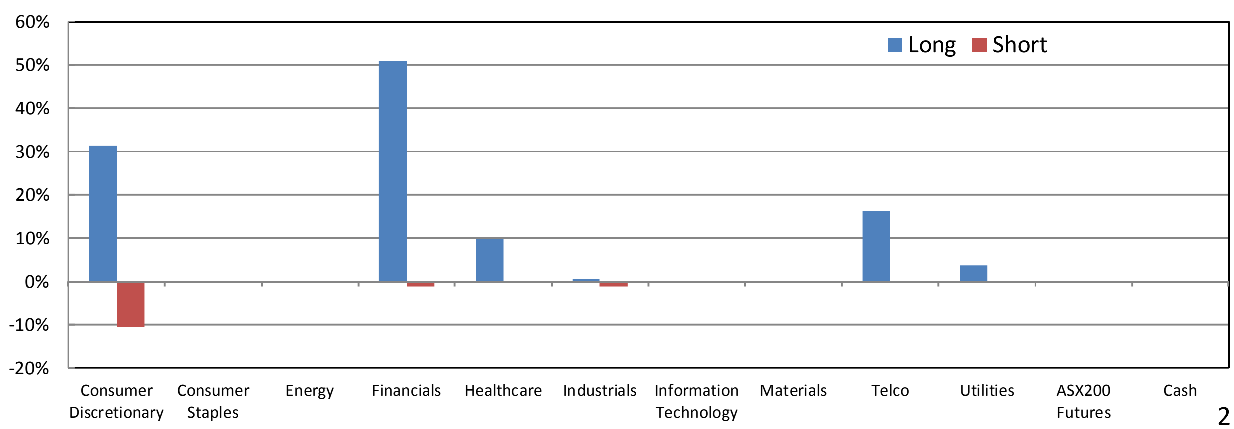
Fund Returns

Period	Auscap	Benchmark
December 2013	2.57%	0.21%
Financial Year to date	28.59%	1.28%
Since inception	53.94%	3.02%

Fund Exposure

December 2013 Average	% NAV	Positions
Gross Long	145.6%	35
Gross Short	26.2%	7
Gross Total	171.8%	42
Net / Beta Adjusted Net	119.4%	101.4%

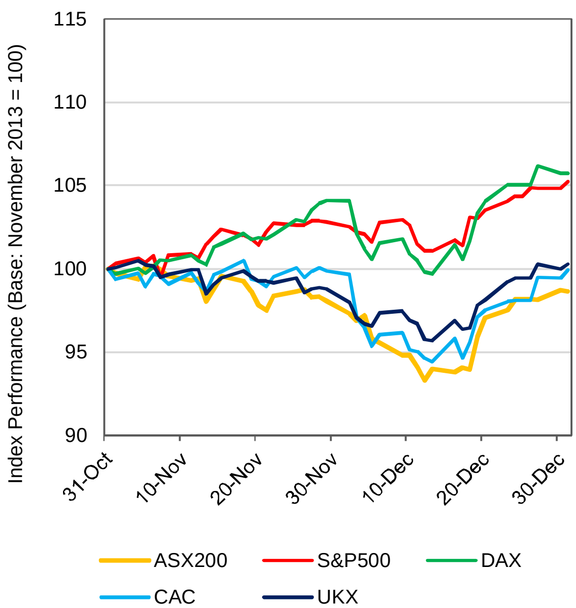
Sector Exposure - 31 December 2013

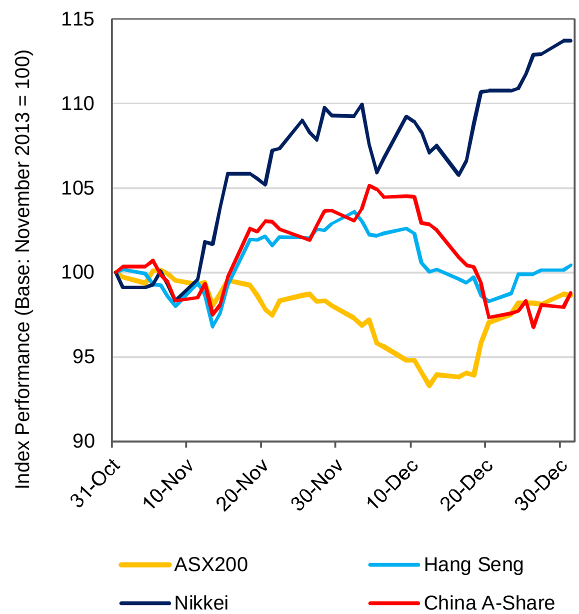


A December To Remember – A Tale Of Two Halves

Well the Christmas Grinch almost stole the traditional December rally for 2013. Despite a large negative move at the start of the month, the All Ordinaries Accumulation Index managed to finish up 0.92%. The 4.6% fall in the first couple of weeks created a buying opportunity, particularly in strong, defensive businesses where declining share prices appeared to reflect an unwind of the “carry trade” in the Australian market rather than any change in the underlying fundamentals of the companies. Certainly the domestic market appeared to be more affected in the lead up to the US Federal Reserve’s announcement of a tapering of its Quantitative Easing policy than other developed international markets.

Major Australian, US, European and Asian Indices: Comparative Performance Nov & Dec 2013



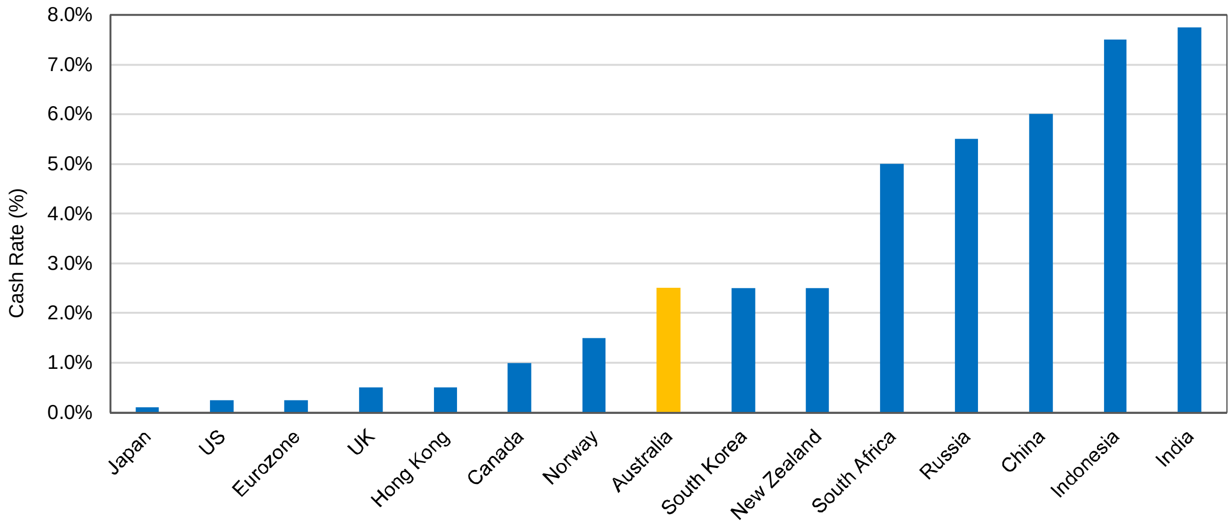


The Fund was unfortunately only partly able to capitalise on the opportunities that became apparent during the month. The fact that we were already reasonably net long going into December precluded us from adding significantly to our positions in quality stocks that were, in some cases, sold to prices below net tangible asset backing and cum distribution.

As our readers would be aware, we have been largely exposed to defensive stocks with strong, sustainable and growing dividend yields. While we continue to like these stocks from a medium and long term perspective because of the absolute returns they offer investors, we must also be cognisant of the fact that they get caught up in the great carry trade that the Australian market finds itself frequently caught up in.

The carry trade is the purchase of assets in a high yielding country and the sale, shorting or borrowing of assets in a low yield country to fund the purchase. As long as the asset prices do not deviate substantially, the holder of this trade collects the yield differential between the two assets. As hard as it might be to believe, Australia, with a cash rate at 2.5%, represents one of the highest yielding developed markets in the world. It is also one of only 13 countries with a Triple A Standard & Poor’s credit rating. The cash rates in the US, UK, Eurozone and Japan remain well below 1% as these developed markets struggle with high unemployment and low growth. Hence Australia represents an attractive place to invest on the long side of the carry trade.

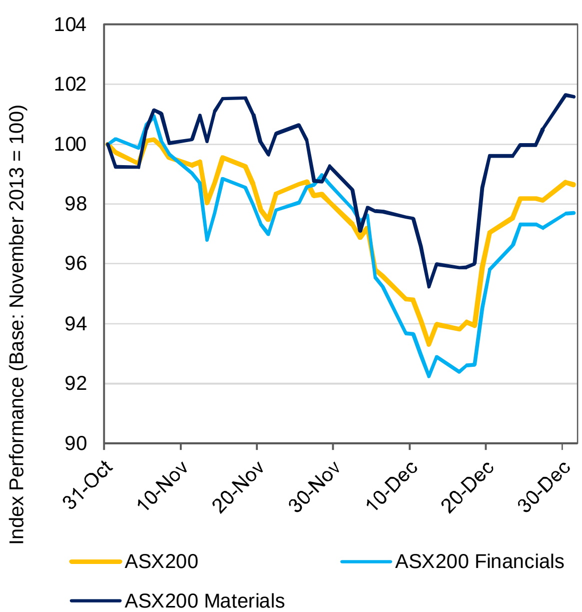
Select Central Bank Cash Rates (as at 17 January 2014)



The US Federal Reserve has been implementing its most recent version of quantitative easing, involving the monthly purchase of $85bn of mortgage backed securities and long term treasury securities, since December 2012. The market again became concerned with the consequence of reduced stimulus by the Federal Reserve during December 2013, leading up to the announcement on 18 December to reduce purchases to $75bn per month.

While we are reasonably confident that any such action is unlikely to have any lasting material effect on the earnings of the companies that we are invested in, it can and does have an impact on the price that these assets trade for in the domestic equity market. An unwind of any carry trade can depress prices in the higher interest rate countries. While this is positive for long term investors, because it creates more attractive purchase prices, one must be in a position of surplus cash to take advantage of these opportunities.

ASX200 Performance vs Various Subsectors



While we cannot and do not try to forecast the direction of markets, we do believe that we should be able to appreciate when sentiment is extremely bullish, for this is a normal warning sign of an imminent pullback. As active long short managers these are the opportunities which, if foreseen and acted upon, can create meaningful value for our unitholders. There were a number of signs pointing to a bullish consensus opinion within the market in the lead up to December, including:

- The heat in the Initial Public Offering market represented by the volume and pricing of new floats, including some issues probably best described as speculative.
- Consensus expectations for a Christmas rally (indeed we probably gave too much credence to the supportive historical data).
- Anecdotal evidence of significantly increased participation in the stockmarket by retail investors.
- A preponderance of bullish commentators discussing equity markets and an absence of bearish or cautious statements in newspapers, magazines and market related emails.

The tapering announcement was a useful catalyst for a pullback. While we had reduced our exposure to more cyclical stocks that had appreciated strongly in the months leading up to December, our gross and net long positions in the market were both still substantial. Given our recognition of frothy and excitable markets, we should have reduced our exposure and waited for the inevitable opportunities. While the Fund still enjoyed a strong month, we were not able to take advantage of the opportunities on offer during December as much as we would have liked. Having said that, the market frequently provides such opportunities and will continue to do so. Our focus at Auscap has been and will remain on investing in quality businesses at prices that we believe minimise the risk of serious and permanent loss of capital. To that end our interests as principals are firmly aligned with those of our investors given our significant co-investment in the Fund.

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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