Auscap Long Short Australian Equities Fund Newsletter – September 2013

Welcome

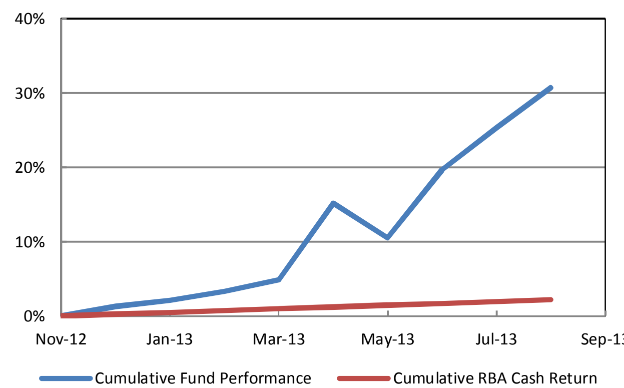
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we look at the logic behind why we prefer to invest in large and mid cap companies, favouring characteristics that include familiarity, a proven competitive advantage, a strong track record of return on equity, recurring cash flow and stock liquidity over the growth prospects of the small and micro caps.

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 4.28% net of fees during August 2013. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 96.1% long and 35.0% short. Average net exposure over the month was +61.1%. At the end of the month the Fund had 22 long positions and 13 short positions. The Fund's biggest exposures at month end were spread across the consumer discretionary, financials, healthcare and telecommunications sectors.



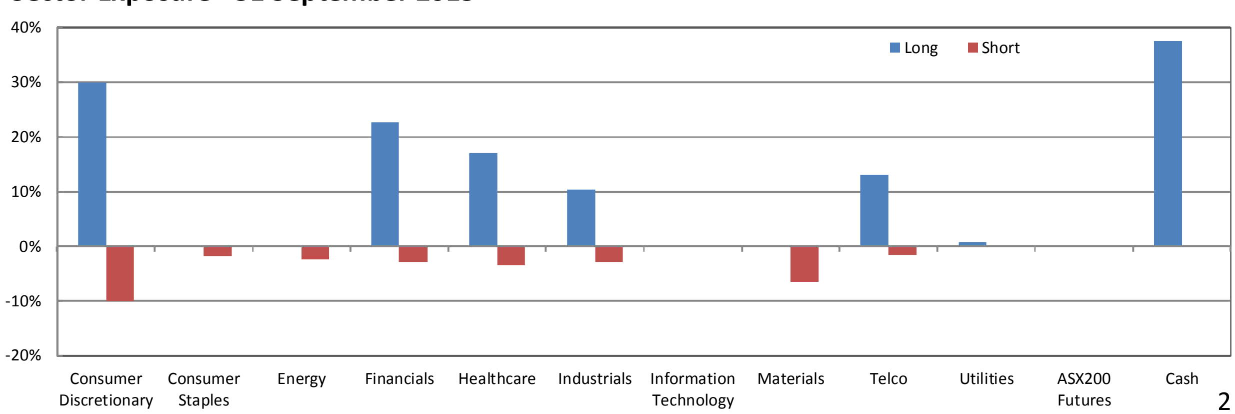
Fund Returns

Period	Auscap	Benchmark
August 2013	4.28%	0.21%
Financial Year to date	9.19%	0.44%
Since inception	30.72%	2.17%

Fund Exposure

August 2013 Average	% NAV	Positions
Gross Long	96.1%	26
Gross Short	35.0%	12
Gross Total	131.1%	38
Net / Beta Adjusted Net	61.1%	35.3%

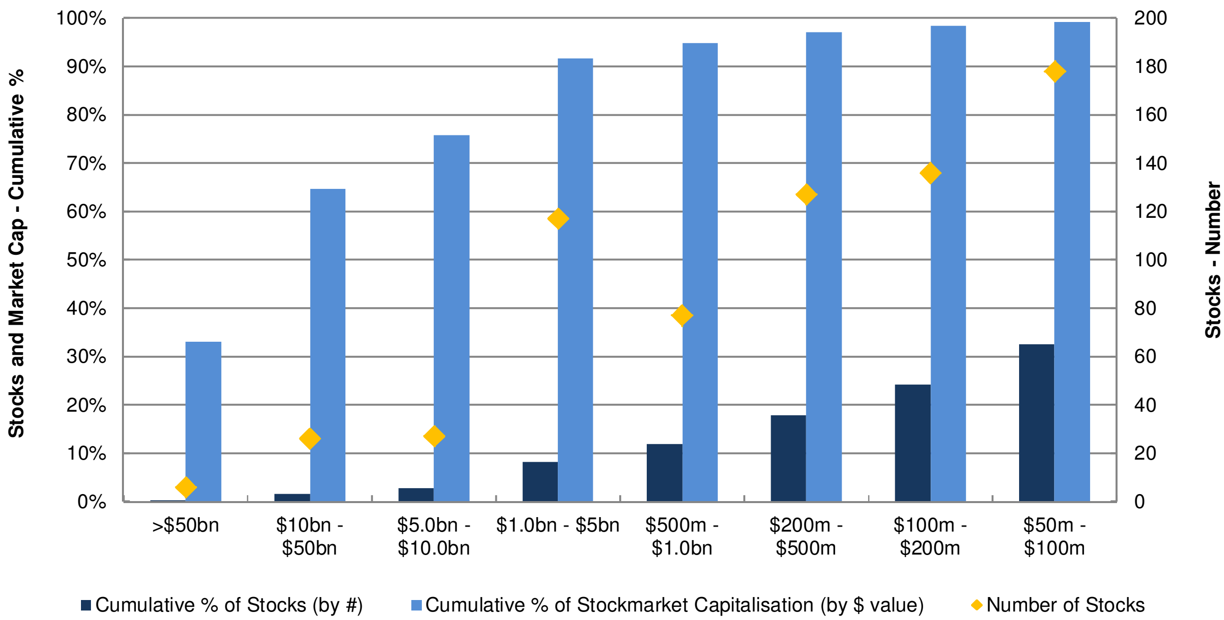
Sector Exposure - 31 September 2013



Risk and Reward: The Case for Size and Liquidity

Small capitalisation stocks ("small caps") are often considered exciting. They are companies with little or no current earnings but plenty of growth potential. They are popular with both professional and part time investors, who beaver away looking for hidden opportunities, trying to find the next Australian corporate success story. Indeed plenty of investors spend time looking at stocks that could potentially go from having a market cap of $100m to $1bn, the so called ten-bagger. And there is merit to this strategy. At Auscap though, we prefer to invest in companies in the large cap and mid cap universe. While numerous definitions abound for what constitutes a large, mid or small cap stock, our preference is for stocks that are currently in, or have the same liquidity and market capitalisation as, stocks in the ASX200. Our intention is to explain the rationale behind this strategy.

ASX Listed Stocks by Market Capitalisation



Small end of the market: over 82% of ASX listed stocks by number have a market capitalisation of less than $200m, with over 1400 stocks in the sub $50m category (not shown above).

Investing in familiar companies

We typically like to invest in a company where we are, or know people who are, customers of the firm. We prefer investing in companies where we understand the product or service, view the offering favourably, and know why the product or service is likely to maintain the favour of its customers. We are more likely to understand the long term viability of a company if the business model is reasonably straightforward and we know why it has been successful in selling its product or service. This produces a natural bias towards companies that provide services across the country, which tend to have significant market presence and typically larger market capitalisations.

"Experience taught me a few things. One is to listen to your gut, no matter how good something sounds on paper. The second is that you're generally better off sticking with what you know. And the third is that sometimes your best investments are the ones you don't make."

Donald Trump

More likely to have a competitive moat

Companies that are reasonably established are more likely to have a sustainable competitive advantage (or competitive moat) that is unlikely to come under threat from new competition. A sustainable competitive advantage might be a dominant position in a market with high barriers to entry; a low cost provider who has economies of scale; a powerful brand or strategic asset; or a unique offering that is not easily replicated. We believe in owning companies that have a natural and ongoing advantage over their competitors which protects margins and profitability.

"Know what you own, and know why you own it."

Peter Lynch

Proven return on assets and equity

Generally it is the large and mid cap companies that have a demonstrated history of strong returns on assets and equity. Given that these are key criteria in our analysis, and our preference is for a demonstrated history of meeting return requirements, it is unlikely that a small company will have sufficient financial history to justify a substantial investment. Established companies are likely to have historical accounts, allowing for through-the-cycle analysis of their returns.

“If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes.”

Warren Buffett

Stronger free cash flow

We prefer to buy companies with strong cash flow. Generally small companies are spending significant amounts of cash on growth capital expenditure (“capex”). This often makes it difficult to understand how much cash flow the underlying business is generating. The difference between maintenance capex and growth capex is an important distinction. The ability to differentiate one from the other is more likely in an established organisation. As investors we are interested in the ability of a company to generate ongoing and sustainable free cash flow that can be distributed to shareholders or reinvested if there are opportunities that meet return requirements.

“Cash is a fact, profit is an opinion.”

Alfred Rappaport

Less reliant on management

Whereas large organisations typically run themselves, key personnel are more important in a small organisation. This is not to say that a large organisation does not have key personnel, but a large, high quality company’s continued profitability and shareholder returns are unlikely to be significantly affected by individual actions, possibly excluding large scale corporate activity, which often has an unfortunate history of destroying shareholder value. We favour companies where the business generates strong returns irrespective of who is running the business.

"I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will."

Warren Buffett

Stock liquidity

We invariably (but hopefully not too consistently) make mistakes when investing. We are guaranteed to make mistakes in the future. However, we are not afraid to admit when we are wrong and/or change our view. This might be due to a change in economic conditions, a change in company direction, new information coming to light or a simple change in our perspective. When we do change our mind on an investment, we exit the position in a timely manner. For that reason we have a strong preference towards investments with good turnover. Small caps are frequently described as lobster pots in this regard due to their illiquidity. It can be relatively easy to get in and establish a position, but getting out can prove a far more difficult exercise.

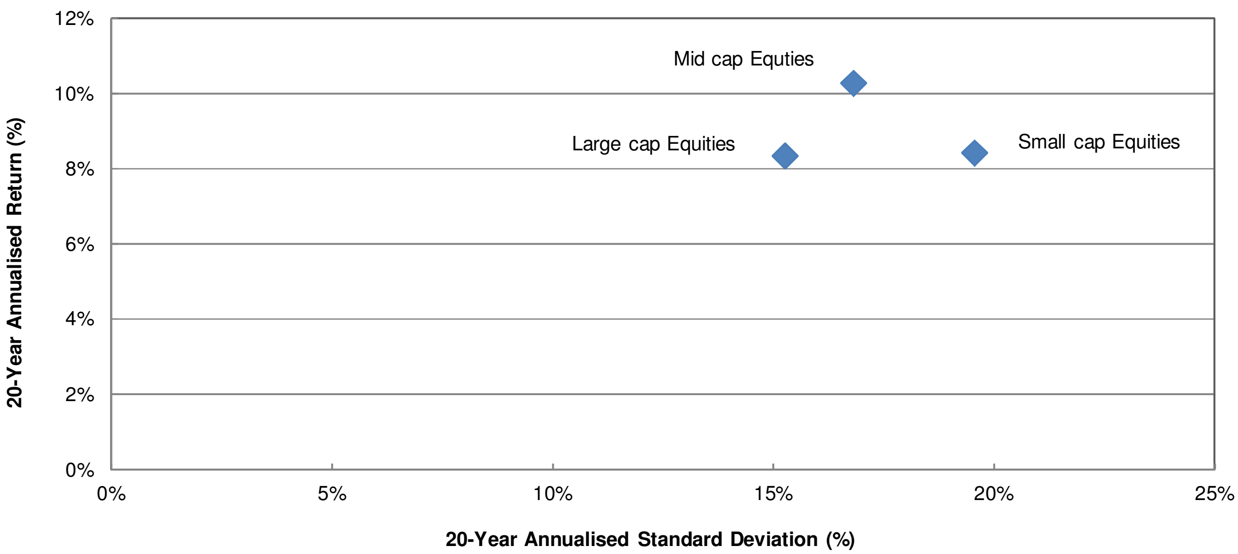
"I'm only rich because I know when I'm wrong… I basically have survived by recognizing my mistakes."

George Soros

Lower Potential Returns?

The argument is often made that the greatest potential for return is provided by small cap companies. This is no doubt the case in specific instances. However, evidence suggests that over time small caps may not offer, in aggregate, the best returns. A broad analysis of the returns provided by the small cap equities within the Russell 2000 Index[i] in the US over the past 20 years demonstrated that they had not provided investors with higher overall returns than the large and mid cap stocks in the Russell 1000 Index[ii] and the Russell Midcap Index[iii], despite exhibiting greater return volatility.

Risk Return Profile of Small, Mid & Large Cap Equities across the Russell Indices



Source: Goldman Sachs Asset Management, "The Case for Mid-cap Investing", June 2013

The results support the theory that, over a broad sample set, investing in large and mid cap companies provide a better risk adjusted return for investors over time. It should be noted that this is not to suggest that the specialist small cap managers, with their significant expertise and diligent analysis, cannot significantly outperform what is a broad index containing many sub-investment grade stocks on a risk-adjusted basis. Our view is simply that we prefer to play predominantly in a familiar backyard, and history demonstrates that over time the large and mid cap universe offers no fewer opportunities for generating strong risk adjusted returns.

Do we invest in any small cap stocks?

While our focus is therefore on large and mid cap companies, typically those within the ASX200, we do look at and invest in the occasional small cap company. In a portfolio of 25 to 45 stocks we might typically have 3 to 5 small cap positions. Liquidity is a significant consideration for us, and the positions will not ordinarily constitute more than a few percentage points of the total funds under management. We have a strong value bias in relation to these small cap positions and must be able to value the business on a sustainable cash flow basis. We are very unlikely to invest in a company which does not currently generate positive cash flow, which we would generally regard as a speculation rather than an investment. The opportunity must be compelling enough to offset any additional risk associated with investing in a small company.

We believe there is sound logic behind a focus on investing in large and mid cap companies. As a group, these companies are more likely to have the characteristics and attributes that we look for in a long term investment. As always, our continuing focus will be on investing in good companies that we believe will generate strong compounding returns for our unitholders over time.

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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[i] Russell 2000 Index: the small cap benchmark index of the bottom 2,000 stocks in the Russell 3000 Index
[ii] Russell 1000 Index: the large cap index of the top 1,000 stocks in the Russell 3000 Index
[iii] Russell Midcap Index: the bottom 800 stocks in the Russell 1000 Index