Auscap Long Short Australian Equities Fund Newsletter – June 2013

Welcome

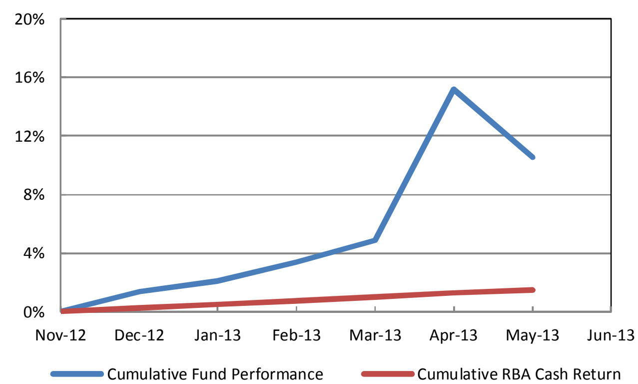
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we look at earnings expectations across the ASX200, highlighting a few sectors that we think are unlikely to match the expectations of analyst forecasts for earnings growth over the 2014 financial year.

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 – 4.05% net of fees during May 2013. This compares with the benchmark return of 0.24%. Average gross capital employed by the Fund was 162.3% long and 31.2% short. Average net exposure over the month was +131.1%. At the end of the month the Fund had 25 long positions and 14 short positions. The Fund's biggest exposures at month end were spread across the consumer discretionary, financials, utilities telecommunications and materials sectors.



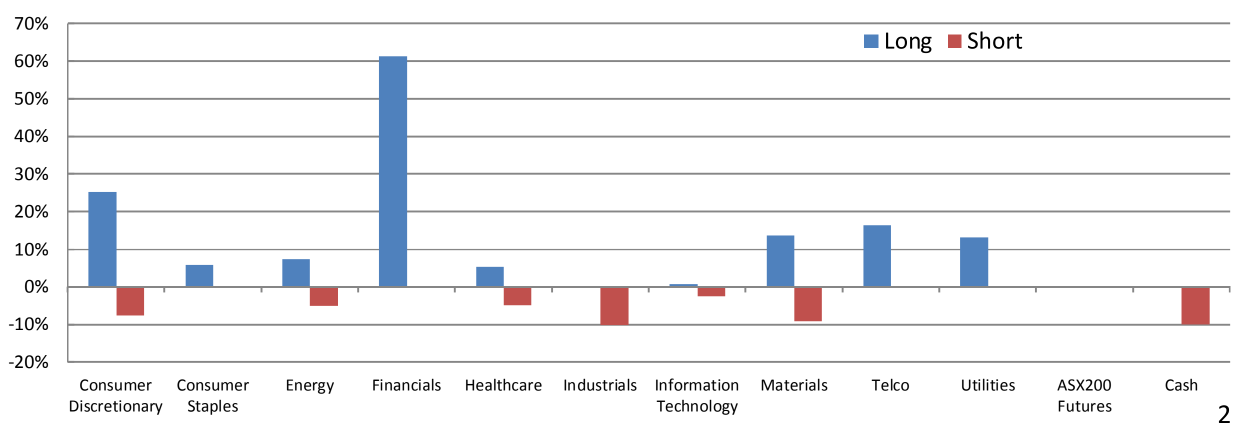
Fund Returns

Period	Auscap	Benchmark
May 2013	- 4.05%	0.24%
Financial Year to date	10.52%	1.50%
Since inception	10.52%	1.50%
Unit Price	1.1052	1.0150

Fund Exposure

May 2013 Average	% NAV	Positions
Gross Long	162.3%	31
Gross Short	31.2%	10
Gross Total	193.5%	41
Net	131.1%	

Sector Exposure - 31 May 2013



Great Expectations – Making Cents Of Forecast Dollar Earnings

We spend a significant amount of time analysing the macroeconomic environment and likely growth in revenues and earnings in various sectors. We think this is important because a rising tide will lift all boats and a falling tide will provide a headwind to the profitability of all companies. We are firmly of the view that we are going into a low and potentially negative domestic growth environment.

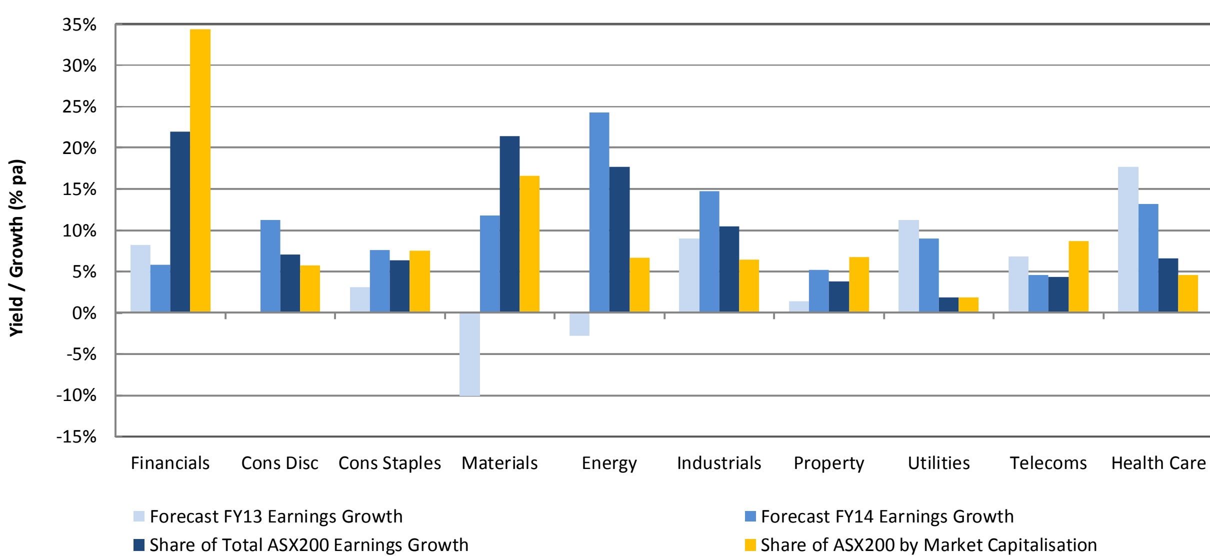
Since the Fund's inception we have invested in companies with steady and sustainable earnings that have realistic expectations for growth in earnings over time and are not facing significant sector related headwinds. In April these companies became all the rage, largely a function of the flow on effect of an announcement by the Bank of Japan that they would engage in large scale quantitative easing. The carry trade was applied en masse and strong companies with good dividend yields appreciated far more quickly than would normally be expected, as indicated in our April newsletter.

In May mixed signals about the US quantitative easing program were given by the Federal Reserve. In his prepared statement on May 23 to the congressional joint economic committee, Chairman Ben Bernanke reiterated that the Federal Reserve has no intention of cutting short its $85bn a month quantitative easing program in the near future. However, in question time Bernanke suggested that the Federal Reserve might start to slow the pace of asset purchases "in the next few meetings". This led to a race to unwind the carry trade and subsequently all that had appreciated in April depreciated by the end of May to prices that were roughly in line with where they had been at the start of April.

We hold positions in high quality companies because of the returns they offer to our investors over time. Some of these companies have been undoubtedly caught up in the carry trade[i]. We did not buy them because of the actions of the Bank of Japan and we have not rushed to sell them because of the actions of the Federal Reserve. During what has been a volatile few months we selectively added to and trimmed our positions, enabling us to hold onto a significant part of April's performance in a period in which these stocks were, start to finish, largely unchanged. But ultimately we continue to hold positions in companies that pay sustainable dividends to shareholders, are likely to have consistent earnings growth over time and reinvest in growth opportunities where it is prudent to do so.

The same cannot be said for the market as a whole where, on balance, we believe that earnings expectations are too high for FY14 and beyond. Forecast earnings growth by sector for FY13 and FY14 are shown below (source: Bloomberg).

ASX200 Sector Analysis



We expect that, with only a few weeks left in FY13, the estimated earnings for this financial year (and hence earnings growth on FY12) will be reasonably accurate, as companies have given guidance at their half year and third quarter results as to management expectations for full year earnings. To the extent that market expectations differ materially from likely full year results, listed companies are obliged to inform the market. Based on the likely outcome of FY13 earnings growth on FY12, we think that FY14 earnings forecasts are generally too optimistic, especially in particular sectors.

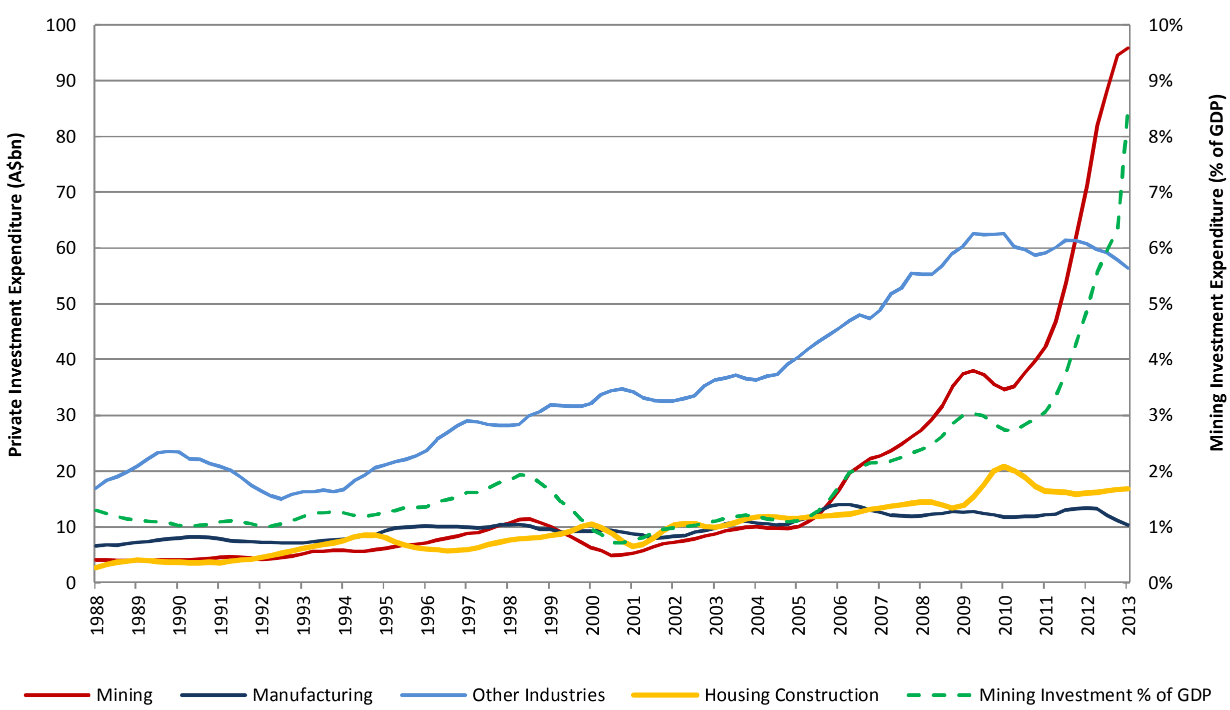
Earnings for companies within the ASX200 are forecast to grow slightly more than 9% in FY14, substantially higher than the sub 4% growth expected in FY13. The sectors with the biggest expectations for growth are Energy (24.3%), Industrials (14.8%), Health Care (13.2%), Materials (11.8%) and Consumer Discretionary (11.3%). The main contributors to total aggregate growth by sector are the Financials (22%), Materials (21%), Energy (18%) and Industrials (10%) sectors, accounting for over 70% of the earnings growth in FY14. We suspect that the forecast growth for many sectors remain too high.

Industrials Sector Growth

Specifically, the forecast growth for the Industrials sector looks ambitious. Given FY13 is looking like it will be a peak year in terms of investment expenditure across Australia, and over 45% of the sector by market capitalisation is directly exposed to mining sector investment, it is hard to see earnings growing strongly in FY14 from what is a high base in FY13. In fact, our expectation is that earnings have a significant likelihood of falling year on year and detracting from overall growth in earnings in FY13.

Mining capex has been the predominant driver of significant earnings growth in the Industrials sector. Some form of mean reversion in investment spending in mining will lead to a contraction in revenue opportunities in the Industrials sector with a potentially magnified impact on earnings as those companies that have increased their cost base and gearing through the boom struggle to reduce overheads during the slowdown.

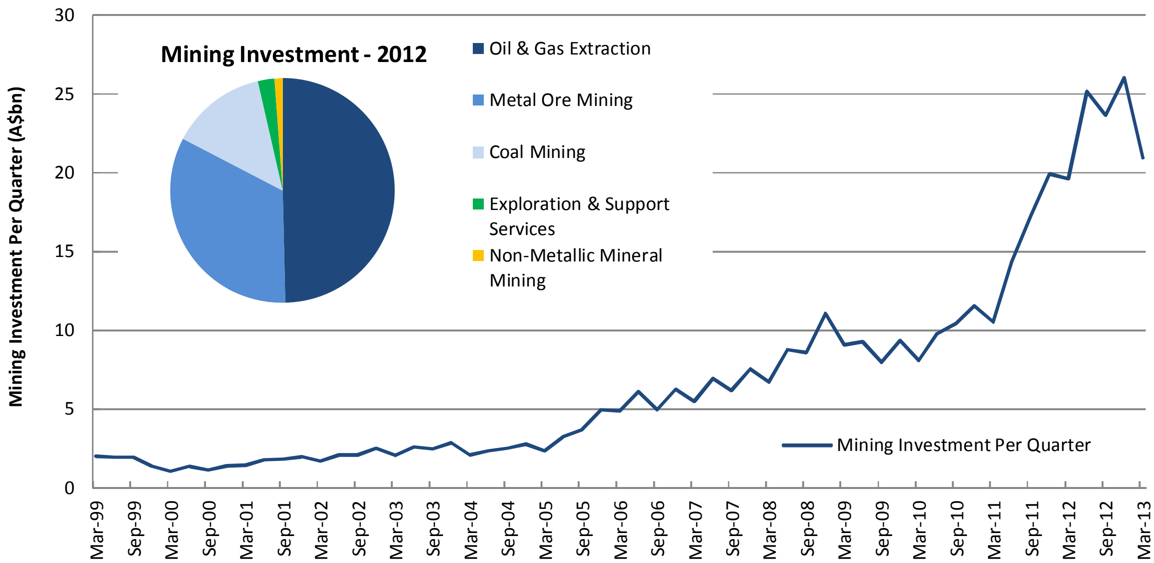
Sector Contributions to Private Investment



Source: Australian Bureau of Statistics

Mining investment appears to have peaked and will likely detract from broad measures of GDP growth over the coming years.

Mining Investment Per Quarter

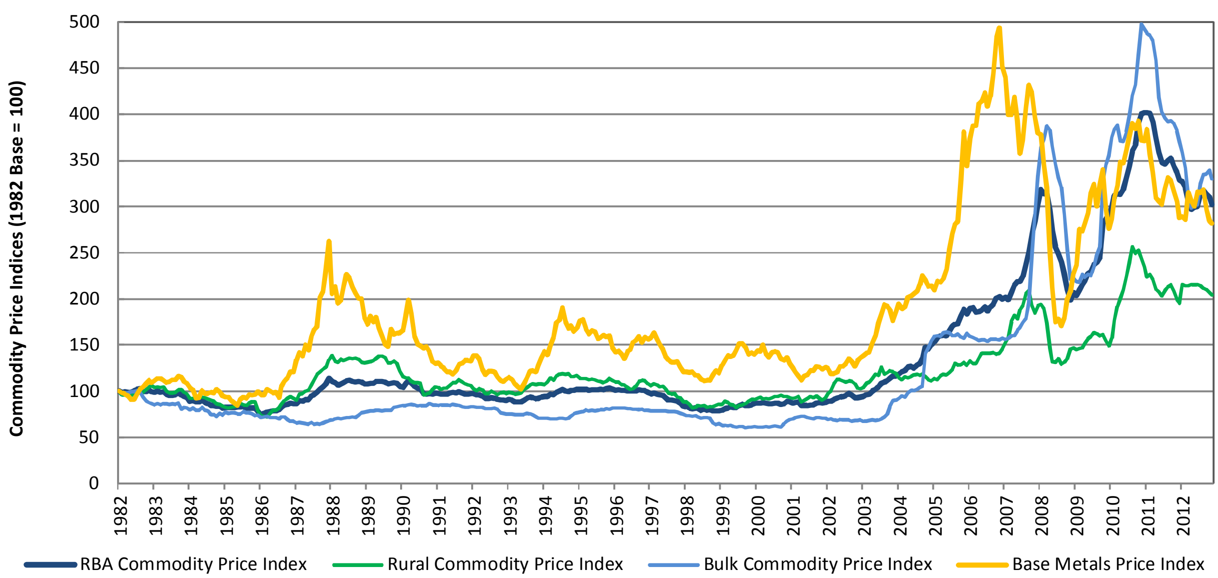


Materials Sector Growth

Commodity prices are likely to continue to decline over coming years. With most commodities exhibiting steep marginal cost curves, it is unlikely that increasing production volumes will offset the impact of declining commodity prices on company earnings. This has been demonstrated in FY13 with earnings forecast to decline more than 10% compared with FY12 earnings. We anticipate another year of declining earnings in FY14, contrary to current market expectations for 10%+ growth.

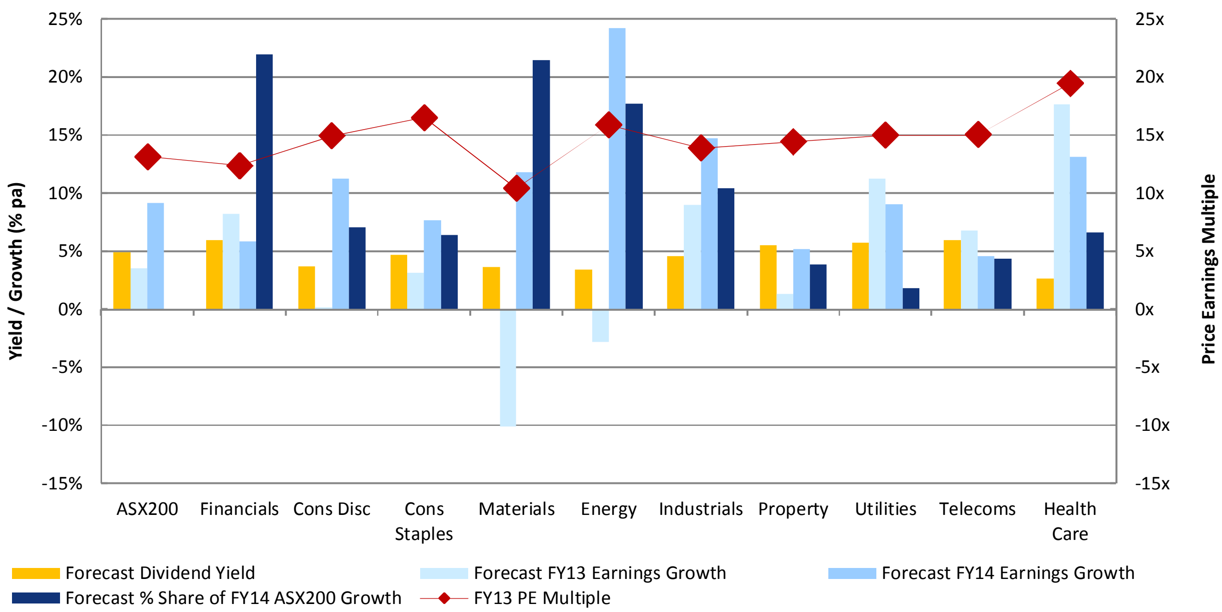
The RBA Commodity Price Index is likely to continue to revert to pre-boom levels gradually over time.

RBA Index of Commodity Prices (USD)



The earnings of those companies within the Industrials and Materials sectors are broadly reflective of investment expenditure and export earnings, two significant components of Australian GDP. To the extent these two components of GDP are under pressure, it will make it difficult for GDP more broadly to grow strongly in real terms. Slow growth in these sectors will impact company revenue growth in other sectors, such as the financial companies that lend to these sectors. Similarly, government budgets will be under pressure and this may impact those industries largely funded by the public purse, such as the Health Care sector where earnings expectations are high and somewhat priced in, given the multiple the sector currently trades on.

ASX200 Sector Analysis



In what we expect to be a low growth environment for Australia over the next 3-5 years as commodity prices adjust to their long run marginal cost of production and the excesses of the mining boom dissipate, we prefer to invest in companies with low risk sustainable earnings that are likely to exhibit reasonable growth over this period of adjustment for the domestic economy.

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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Tax & Audit: Ernst & Young
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[i] The carry trade is a strategy that involves borrowing money at a low interest rate and investing that money in a higher yielding asset. The strategy is most commonly employed by borrowing in one country that has low interest rates and reinvested in another country that has higher interest rates.