Auscap Long Short Australian Equities Fund Newsletter – May 2013

Welcome

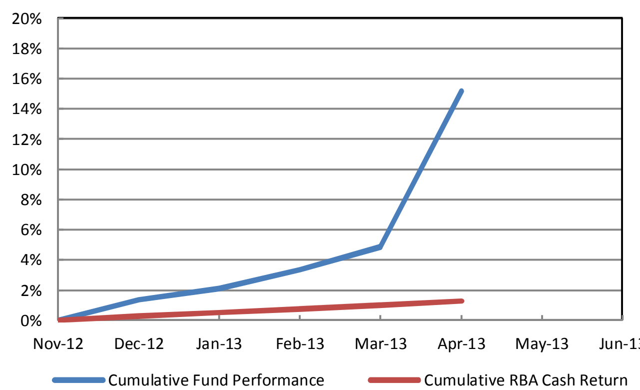
Welcome to the Auscap newsletter, an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we will also discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. In this edition we look at gold, the merits of which as an investment is a contentious subject at all times. We explain our recent thinking and approach to gold equities.

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 9.83% net of fees during April 2013. This compares with the benchmark return of 0.25%. Average gross capital employed by the Fund was 178.0% long and 48.5% short. Average net exposure over the month was +129.5%. At the end of the month the Fund had 33 long positions and 11 short positions. The Fund's biggest exposures at month end were spread across the consumer discretionary, financials, telcos, industrials and materials sectors.



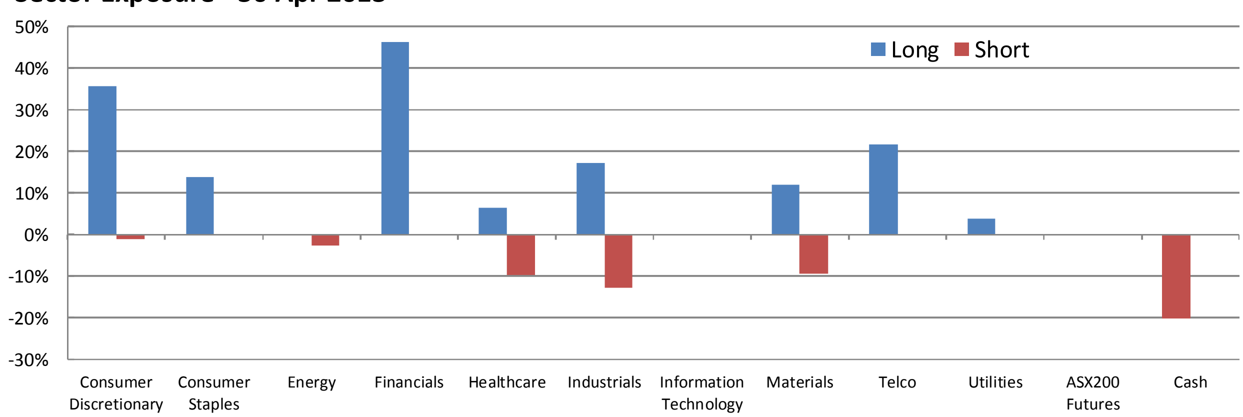
Fund Returns

Period	Auscap	Benchmark
April 2013	9.83%	0.25%
Financial Year to date	15.18%	1.26%
Since inception	15.18%	1.26%
Unit Price	1.1518	1.0126

Fund Exposure

April 2013 Average	% NAV	Positions
Gross Long	178.0%	32
Gross Short	48.5%	11
Gross Total	226.5%	43
Net	129.5%	

Sector Exposure - 30 Apr 2013



Has Gold Lost Its Shine?

The Fund had an unusually strong month in April. Certainly we would caution investors against any expectation of monthly returns in this order of magnitude. A significant portion of the monthly return was due to the Fund's overweight exposure to companies with strong competitive advantages and sustainable earnings that provide investors with a good dividend yield and growth that is anticipated to exceed inflation over coming years. These investments performed very strongly during April, and while we expect them to continue to contribute positively to the Fund over the next few years, one should never expect the sort of monthly capital gains experienced in April.

The other main contributor to the Fund's performance was a short position across a small number of gold stocks that have constituted at most around 10% of the Fund's capital at any point during the month. It is very unusual to have a few positions that move in line with expectations as quickly as they did during the month. Between the start of the month and the middle of the month, when the short positions were closed, the average price fall across these positions was 34% and provided the Fund with a positive 2.8% return. Why were we short gold stocks? What is our view on gold now? And what catalysts did we see to initiate and increase our short positions?

Gold as an investment

There are a number of reasons that people provide as to why they invest in gold. Some suggest that investing in gold provides them with a hedge against inflation. Some consider gold a safe haven asset, especially in times of economic, political or social crisis. Some suggest that the world is likely to move back to a gold standard in coming years. Some suggest that it is a currency hedge protecting them against central banks who have a bent towards devaluing fiat currencies. Ultimately there is only one reason why people invest in gold. They think the price of gold will rise.

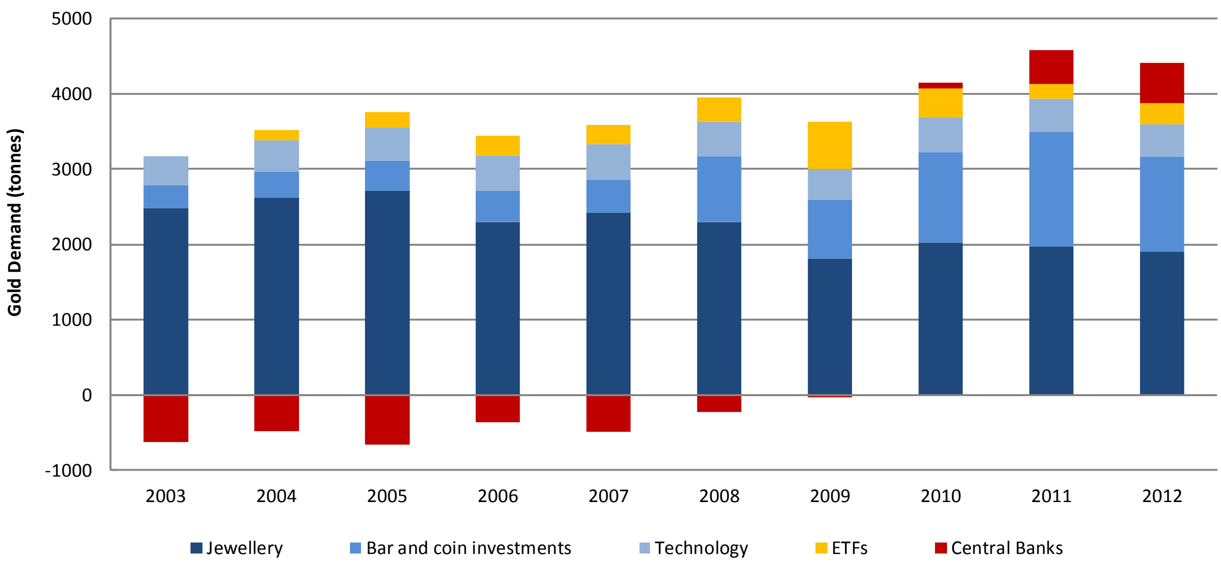
Indeed the price of gold has been rising for a long time.

Gold Price - 1990 to Present

Unfortunately, like any good company or fund disclaimer reminds us, historic performance should not be relied upon as a guide to future performance. Gold is used in jewellery, technology and as an investment. Jewellery demand has been declining as the price of the gold has risen. Of the jewellery driven demand, India and China together generated 56% of total annual jewellery demand in 2012. Technology driven demand is primarily for use in electronics and has been relatively steady over the last decade. Indeed most of the excess demand that has contributed to the rising price of gold has been investment driven.

Gold's widespread popularity as an investment has accelerated in recent years. This investment demand has been from individuals, institutional investors and central banks. There has been the new phenomenon of Exchange Traded Funds (ETF) that purchase and store physical gold in accordance with demand. The first gold ETF, Gold Bullion Securities, was launched in Australia in March 2003. Since then demand for gold from ETFs has grown significantly. Gold has also been in demand recently from central banks whose purchases reached a 48 year high in 2012 in terms of net tonnes bought, accounting for 12% of total demand or 534.6 tonnes[i]. In the last few decades central banks only became net purchasers of gold in Q2 2009.

Gold Demand: 2003 - 2012



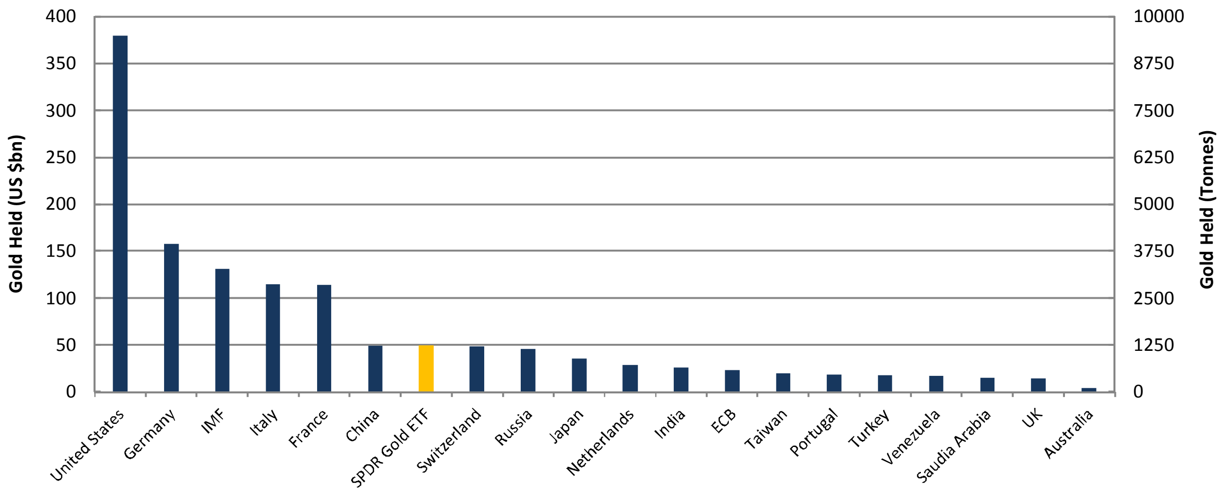
There is no way of telling what these participants are likely to do in relation to their gold holdings going forward. They may increase their holdings if sentiment is positive, or they may reduce them if they feel the price is likely to fall. As an investor, it is particularly difficult to forecast sentiment towards gold and hence the likely future price moves.

Despite its popularity, gold to us does not have the characteristics that would typically define an asset as an investment. It produces no income, therefore pays no dividend. Its value is simply a function of supply and demand for a metal good. Those who hold gold would like to convince us that there are many reasons for doing so. When the herd agrees with them, demand outstrips supply and the gold price rises. When the herd disagrees with them, supply exceeds demand and the price of gold falls. Importantly, when the price of gold falls there is nothing to stop it from falling further. It has no income characteristics that define it as cheap or expensive. In fact gold has a negative yield, because of the cost of holding it. You require safe storage of the metal and insurance against theft, resulting in an expense against an asset that yields no revenue.

As Warren Buffett pointed out in 2011, "If you took all the gold in the world, it would roughly make a cube 67 feet on a side… Now for that same cube of gold, it would be worth at today's market prices about $7 trillion dollars – that's probably about a third of the value of all the stocks in the United States… For $7 trillion dollars… you could have all the farmland in the United States, you could have about seven Exxon Mobils, and you could have a trillion dollars of walking-around money… And if you offered me the choice of looking at some 67 foot cube of gold and looking at it all day, and you know me touching it and fondling it occasionally…Call me crazy, but I'll take the farmland and the Exxon Mobils".

Gold today is potentially more prone to being affected by changes in sentiment than ever due to the influence of ETFs. The SPDR Gold Trust ETF is one of many gold ETF's and the world's largest. Incredibly, it holds more gold than all but five sovereign central banks and the IMF. Until recently it held more gold than the People's Bank of China (PBOC).

World Central Bank Gold Holdings: April 2013



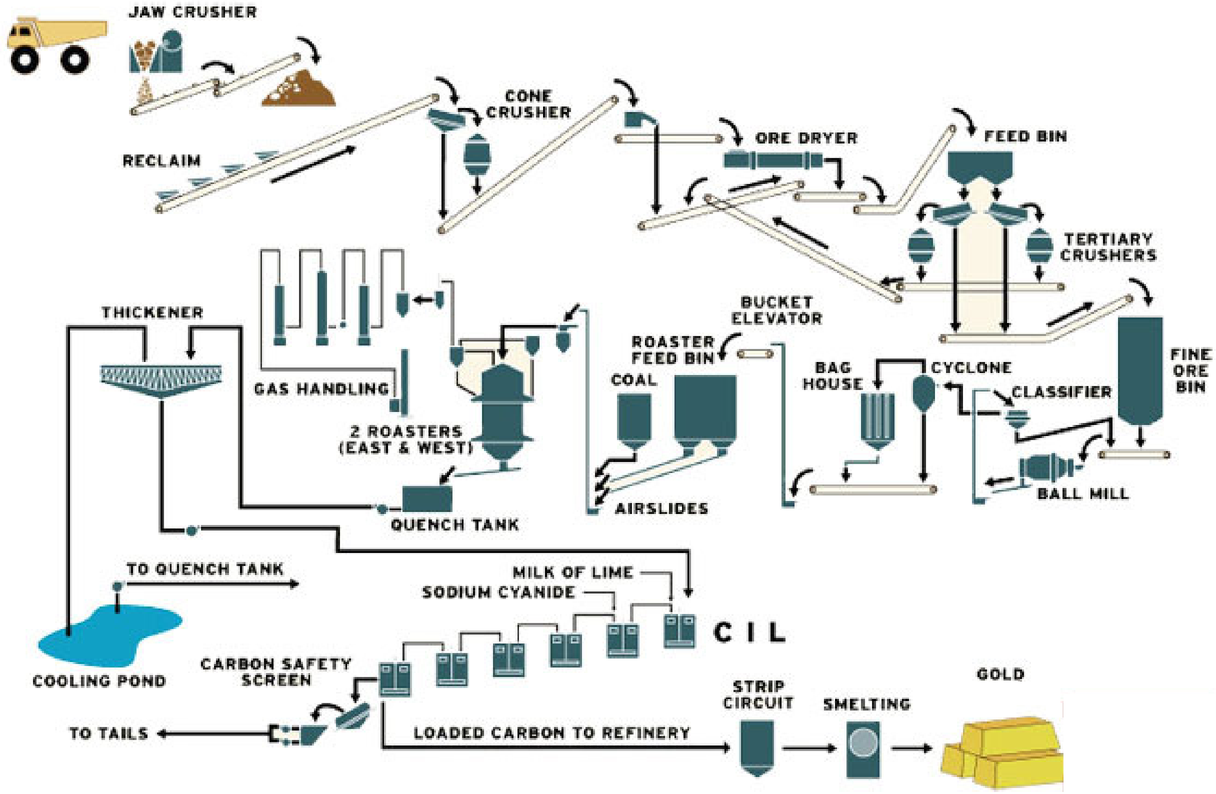
Gold companies as an investment

There are many that would suggest that gold companies are more investment grade because they are defined by their cash flows. They exhibit the characteristics of ordinary companies, with revenues and operating costs that can be forecast to determine profits and/or losses. While this is true, we would argue that this makes gold companies more difficult to value than gold itself. While still subject to the swings and mood changes of the physical price of gold, we add a 9.8 degree of difficulty for trying to generate consistent earnings.

The gold mining process is a complex one. First the company has to find the gold and delineate a resource. 5 inch holes are drilled hundreds of metres deep with spacing between each hole of typically ~20 metres, depending on the resource type. Laboratories then analyse the drill core for minerals. Geologists then extrapolate what was found in these holes to calculate a resource. Unfortunately whether the resource is consistent across these intervals isn't certain and won't be known until the mining commences.

Then there is the process of removing a huge amount of waste material, the overburden, or developing a deep underground mine shaft to expose the gold to the mining process. Once at the resource the mining and extraction process begins. Often gold mining companies have grades in the vicinity of 1 gram of gold for each tonne of material being extracted. Here we are looking for about one tic tacs worth of gold in each 1000 kilograms of material mined. Perhaps finding the proverbial needle in a haystack would be an easier task.

This gold extraction flow chart is typical of what you might expect the process to look like.



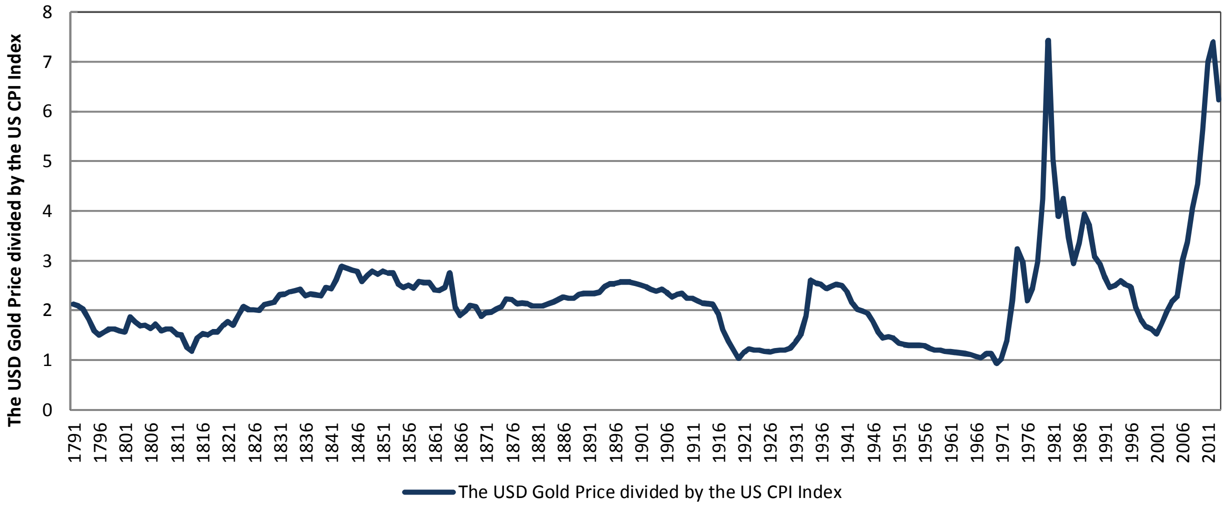
Needless to say it is not an easy process and involves an incredible amount of skill and energy on the behalf of management and the technical team working on the project. But as an investment, relying on this process to generate consistent shareholder returns, even in a steady gold price environment with the best technical team on hand, seems fraught with danger. Recently there have been added dangers lurking in the background for gold company investors, including new mining taxes and the partial nationalisation of gold projects, a fluctuating currency that needs to be managed and the difficulty of finding appropriately skilled staff who agree to work in often remote locations. There has also been a lack of reporting transparency where “all in cash costs” have not seemed to include all of the cash costs of running a gold business. In addition, gold companies have not, in general, had a good track record of returning the cash they do produce to shareholders. If they successfully develop a mine, they are keen to develop another, until eventually they seem to run into trouble with a difficult mining operation.

And then there’s the gold price itself. Most investors do not want gold companies to hedge the price of gold the company receives, therefore they are exposed to the volatility of the gold price itself. Unless you know where the gold price is going, this can only increase investment risk. That is, unless gold is going to rise! Many investors hold gold companies on the premise that the price of gold will rise over time. Let us have a quick look at the reasons provided for gold’s continued appreciation.

Gold as an inflation hedge

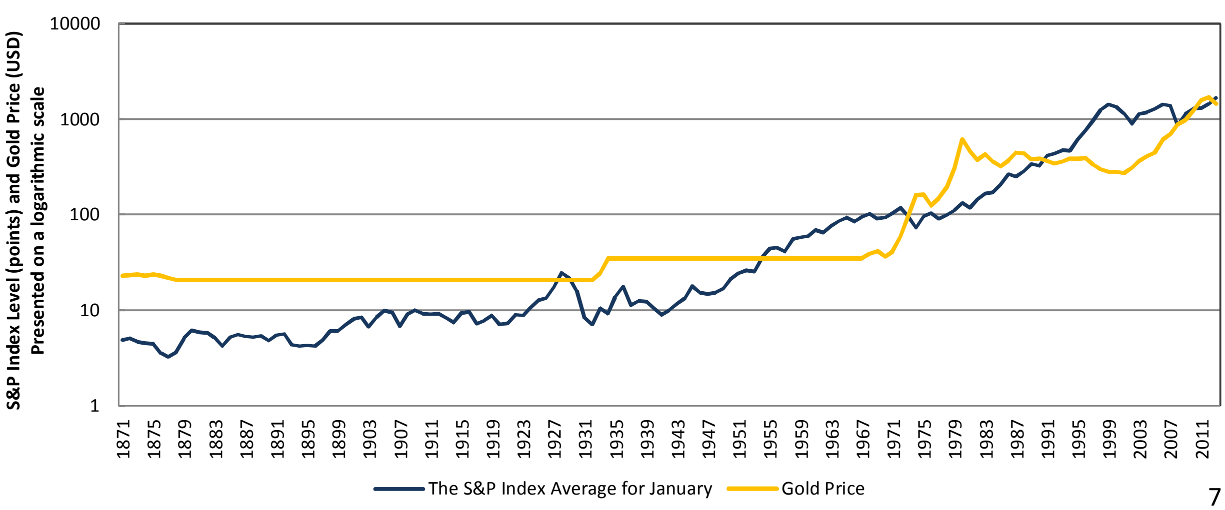
Gold is undoubtedly a *long term* store of value and protection against inflation. In the short term if the reason for buying gold at these prices is to protect against inflation, we feel it may be too late. Gold has significantly outperformed inflation in recent history, largely a result of the price gains over the last decade.

The Real Gold Price: 1791 - Present



The potential for inflation to arise is of course present, with central banks printing money like never before, but to this point inflation has been somewhat benign. Recent money printing has certainly caused asset inflation, with the US market in record territory. But again the gold price has outpaced asset inflation in the short term. Erb and Harvey[ii] suggest that based on the CPI index as at March 2012, the price of gold should be around $780 an ounce. If this is true then gold could fall another 30% and still be well above where it should be to provide investors with a long term inflation hedge. Their analysis of the movement in the price of gold compared with changes in the annual inflation rate from 1975 to 2011 demonstrated that there was very little correlation over the short term. So it seems unlikely that we can rely on the value of gold to hold its current level because of the threat of inflation. Its outperformance compared with the CPI index might even suggest some ongoing mean reversion.

Relative Performance: Gold vs S&P Index

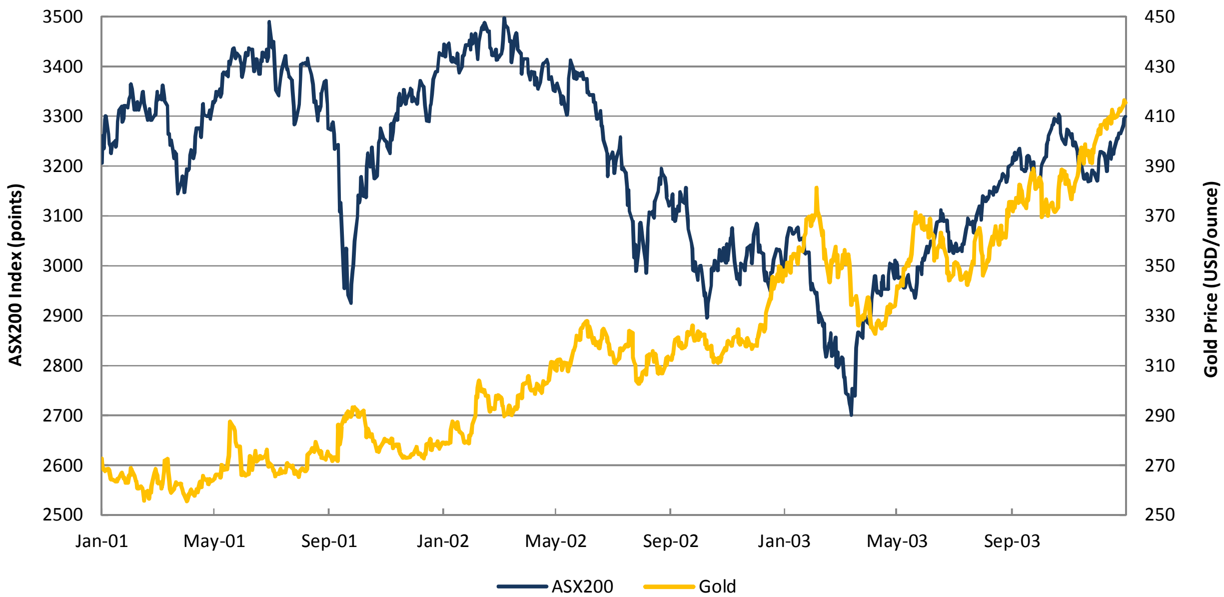


Gold as protection against macroeconomic shocks

Gold is often held as a form of protection against global financial shocks. It is held to be a store of value and protection against periods of declining prices on the stock market, increasing national debt, possible inflation or social unrest. Recent bouts of stockmarket turmoil in Australia suggest that this theory holds some water.

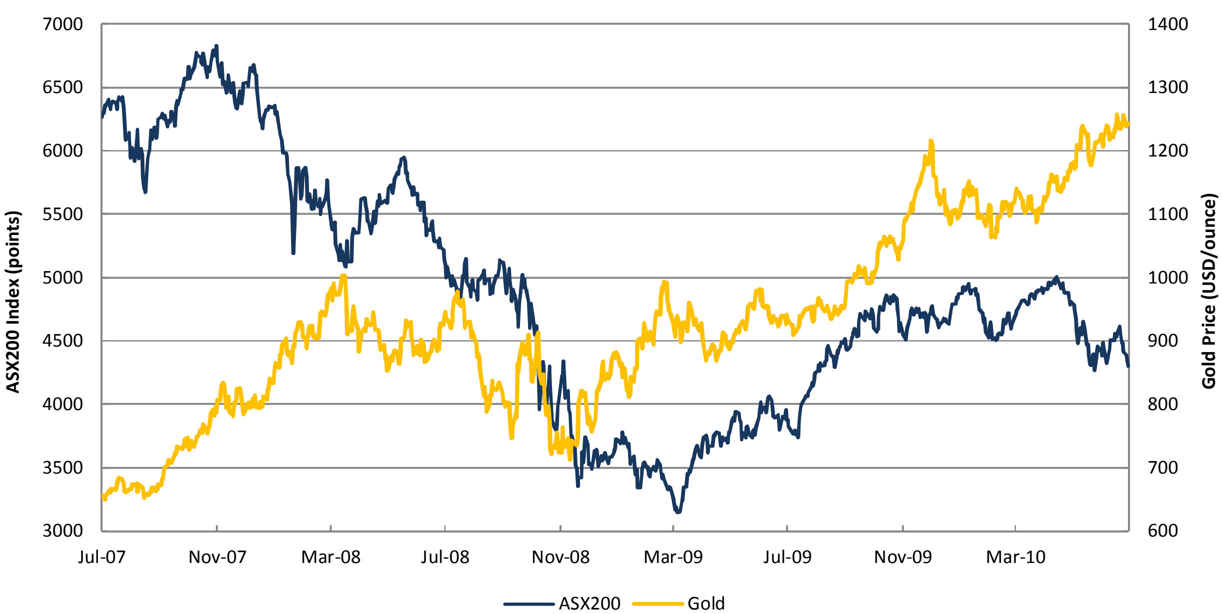
Gold outperformed during the stock market correction in 2002.

Dotcom Correction: ASX200 vs Gold Price



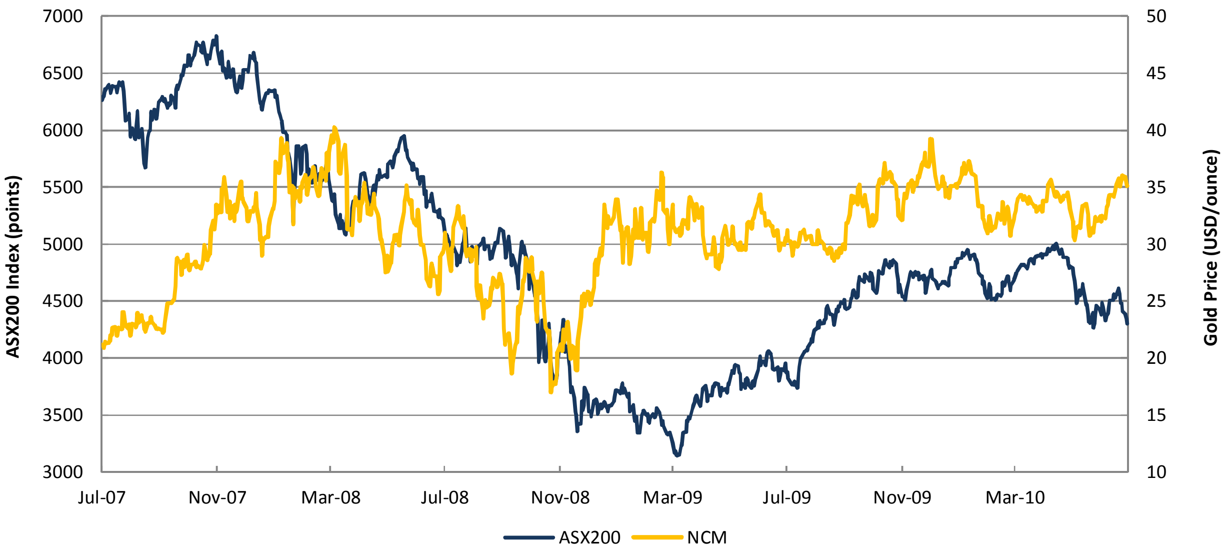
And again during the correction in 2008.

Global Financial Crisis: ASX200 vs Gold Price



It should be noted that we must be wary of drawing too many conclusions from the price of gold during this period. It is difficult to separate the price movements over these shorter periods from the strong bull market that gold experienced from 2000 to 2012. And while gold itself may be a hedge against macroeconomic shocks, the gold companies themselves might not be as good at preserving wealth during a market contraction. Newcrest Mining Limited (NCM), the largest gold company listed on the ASX, fell with the market for the majority of its decline through 2008, albeit it did rebound more quickly than the stockmarket towards the end of 2008 and into 2009.

Global Financial Crisis: ASX200 vs NCM



Gold to return as a monetary standard / protection against currency debasement

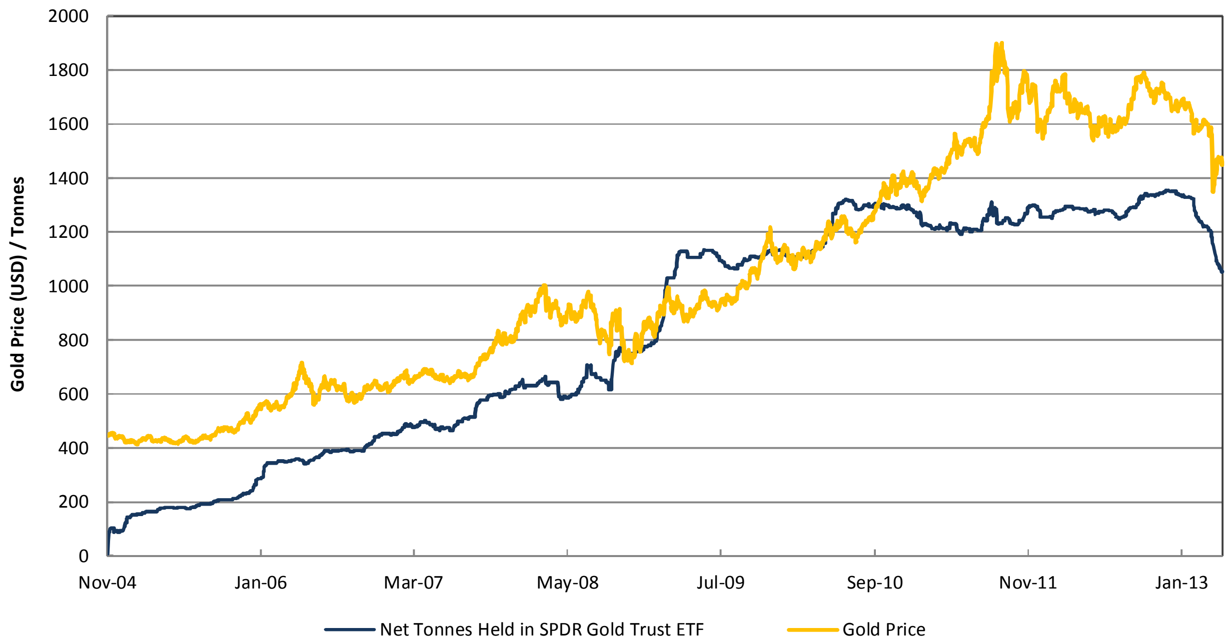
If currency debasement was a reason for the increasing price of gold, then gold priced in Australian Dollars should have been reasonably constant over the last decade because Australia has not been printing money in the way many other nations have. Yet the gold price in AUD has been volatile and far from constant. We think it is unlikely that gold will return as a monetary standard, albeit it may be that at some point a gold-like standard is introduced, where the annual increase in money supply is specifically limited through legislation.

Gold Price in Australian Dollars Per Ounce

Change in sentiment towards gold

Gold shares many characteristics with other commodities, except one. Unlike iron ore, steel, corn, natural gas or cattle, gold does not get "used" in the traditional sense of the word. The quantity of gold is continually increasing because gold that has been mined historically is still in circulation. In fact the total gold mined each year only adds to the existing stock of gold by 1-2%. This is important, because it means that the supply equation is not as affected by the marginal cost of production to extract the gold as other commodities. If gold fell out of favour, as it did recently, the potential number of sellers of gold might so significantly outstrip the number of buyers that a fall below the lowest marginal cost of production would not immediately necessitate a rebound in the price. To us this makes gold a riskier investment, especially after a ten year period during which the price of gold has risen more than 700%. Gold's vulnerability to a change in sentiment amongst those who hold it was exposed recently.

Gold Price and Gold ETF Demand



We have no special edge in determining in the medium to long term whether the price of gold will go up or down. We appreciate that it is most certainly considered as a store of value, and probably always will be. At the same time we think that there are better investment opportunities and we are not currently comfortable owning gold or gold stocks. Some continued mean reversion can probably still be expected in the short term.

Why were we short gold stocks?

As fund managers, we take opportunities to hedge our long investments with short positions at what we consider to be appropriate times. Since the commencement of the Fund we have held the view that many of the gold companies were expensive on the basis that the market underappreciated the risk of a fall in the gold price and the risks associated with operating a gold company. Gold has been an underperforming asset over the course of the last year, despite periods of economic and political uncertainty. For this reason we have had a few small short positions in the gold sector. Part of the process of hedging our portfolio through short positions though is to identify specific catalysts that we think will result in a fall in the price of these stocks.

We identified three catalysts with respect to the gold price towards the end of March and the start of April that gave us confidence that we should add to these short positions.

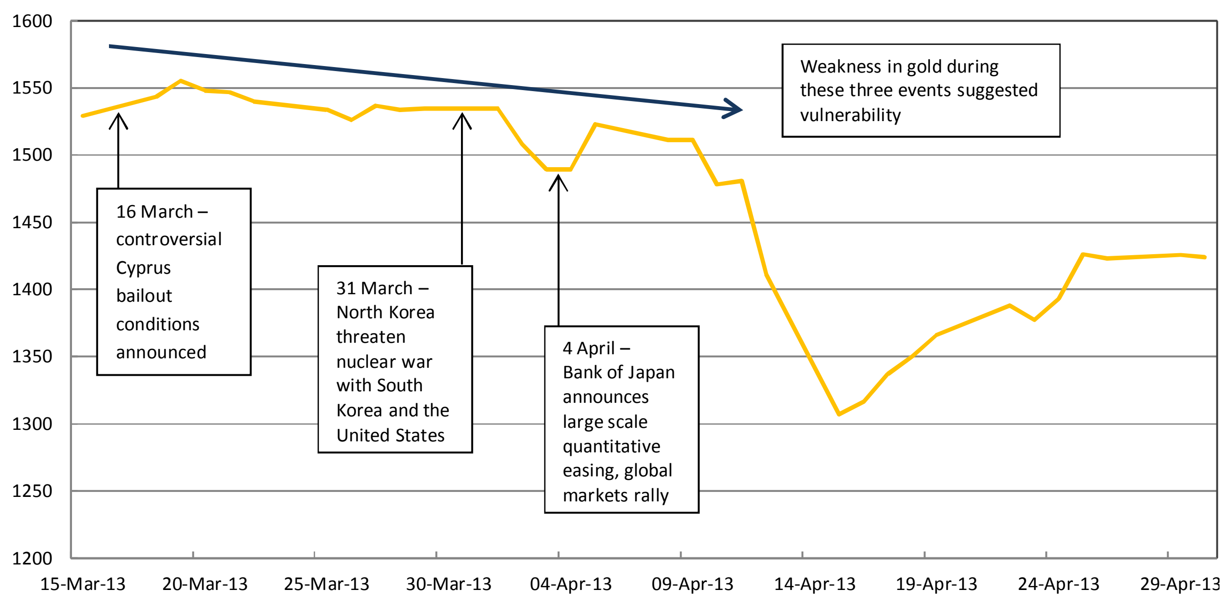
- On the 16th of March a bailout for Cyprus was announced conditional on levying a tax of between 6.7% and 9.9% on deposit holders. The deal required the ratification of the Cypriot Parliament, under the threat of the bankruptcy of the country. The deal was subsequently rejected by the Parliament on the 19th, and a new deal was settled by the 25th of March levying a 40% tax on uninsured deposits in the Bank of Cyprus.

- On the 31st of March North Korea declared a full scale conflict against South Korea, threatening nuclear war. While this has so far been considered largely political rhetoric, it has potentially significant consequences should any conflict eventuate. The threat North Korea posed certainly increased following this announcement and others that followed shortly thereafter.

- On the 4th of April the Bank of Japan announced it was going to pump $1.4 trillion into the economy in an unprecedented effort to stimulate the economy, stoke inflation and end two decades of stagnation. Japanese assets immediately responded, as did markets worldwide. Bonds rallied and equities rallied. In Japan the yield on 10 year Japanese Government Bonds fell to 33 bps (0.33% pa). The Nikkei rose 10% in three days and has risen over 20% in a month.

Typically, a small banking crisis, any increase in the threat of nuclear war and certainly the announcement of large scale globally significant quantitative easing would make the price of gold increase substantially. Yet during this period the price of gold fell.

Gold Price in Australian Dollars Per Ounce



If gold was falling during the short period in which these three events took place, we concluded that gold was vulnerable, especially if the world went into a period of relative economic and political stability. As a result we added to our short gold-exposed positions. We did not expect the rapid deterioration in the gold price that followed but at the same time were not entirely surprised by it.

Conclusion

We suspect that the likely trend for the gold price in the short term is down. The world is in a period of slow growth, little inflation (outside of asset inflation) and relative calm compared with many times during a turbulent last decade. In an environment in which financial fear is subsiding we suspect that the rationale used by investors to justify holding gold will continue to be questioned. To some extent underperformance begets further underperformance as gold fund redemptions play their part, especially given the recent phenomenon of gold trust ETFs. In the longer run, as mentioned earlier, we have no view on the likely trajectory or path of the gold price. But as an investment we prefer to hold financial assets that we can value on the basis of reliable future cash flows.

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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.

Auscap Asset Management

ACN 158 929 143 AFSL 428014
Lvl 24, 9 Castlereagh St, Sydney
Email: info@auscapam.com
Web: www.auscapam.com

Service Providers

Prime Brokerage: Citi Global Markets
Administration: White Outsourcing
Tax & Audit: Ernst & Young
Legal: Henry Davis York

[i] World Gold Council, *Gold Demand Trends*, February 2013, www.gold.org
[ii] Claude Erb and Campbell Harvey, *The Golden Dilemma*, June 6 2012, http://ssrn.com/abstract=2078535