Auscap Long Short Australian Equities Fund Newsletter – January 2013

Welcome

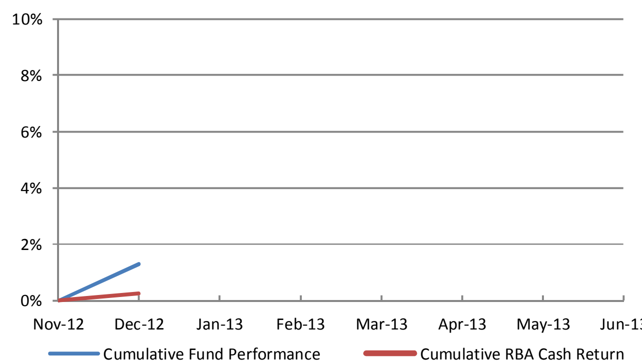
Welcome to Auscap's inaugural newsletter. The newsletter is an opportunity for us to report the performance of the Auscap Long Short Australian Equities Fund ("Fund") to current and prospective investors. In each publication we intend to discuss a subject that we have found interesting in our research and analysis of the market. We hope that you enjoy reading these snippets and encourage any feedback. Given this is our first edition, we thought a discussion of Australia's GDP worthwhile. We focus on what we believe is the key factor affecting domestic economic growth over the next decade, namely China's demand for and consumption of steel. We thank you for your readership and wish everyone a prosperous 2013.

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 high conviction positions primarily in liquid stocks in the ASX200. Further information, including access to the Fund's Information Memorandum for sophisticated investors, is available at our website www.auscapam.com. Correspondence can be directed to info@auscapam.com.

Fund Performance

The Fund returned 1.35% net of fees during December 2012, its first month of operation. This compares with the benchmark return of 0.26%. Average gross capital employed by the Fund was 32.5% long and 27.8% short. Average net exposure over the month was +4.7%. At the end of the month the Fund was long 23 stocks and short 10. The Fund's biggest exposures at month end were in the financials, consumer discretionary and materials sectors.



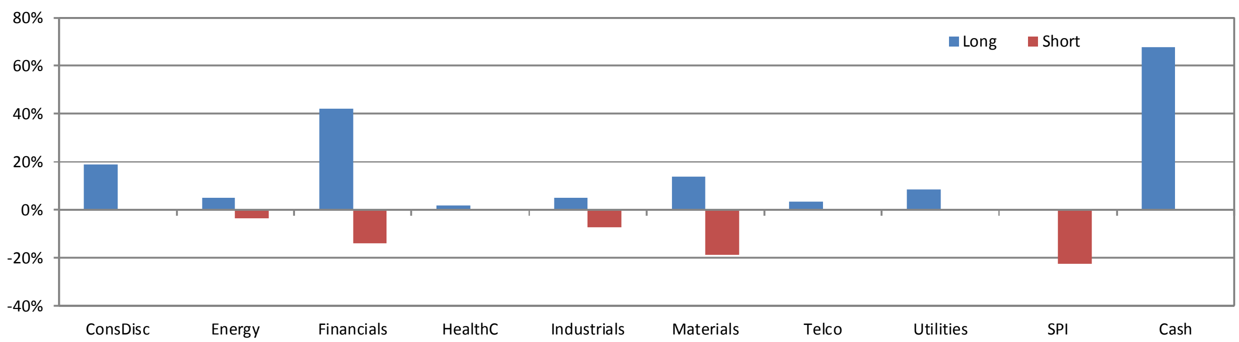
Fund Returns

Period	Month	Benchmark
December 2012	1.35%	0.26%
Year to date	1.35%	0.26%
Since inception	1.35%	0.26%

Fund Exposure

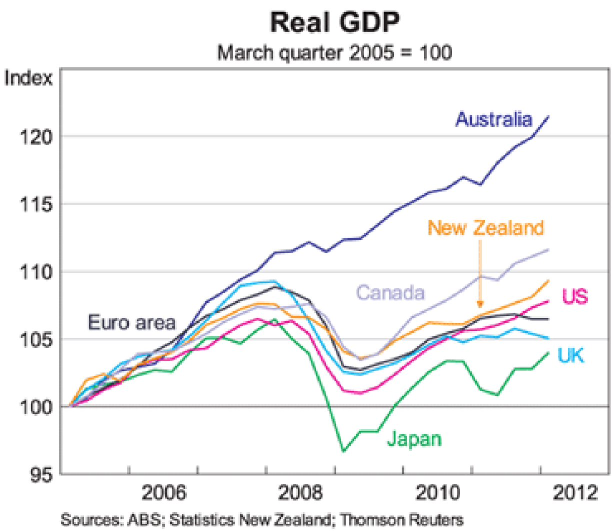
Monthly Average	% NAV	Positions
Gross Long	32.5%	23
Gross Short	27.8%	10
Gross Total	60.3%	33
Net	4.7%	

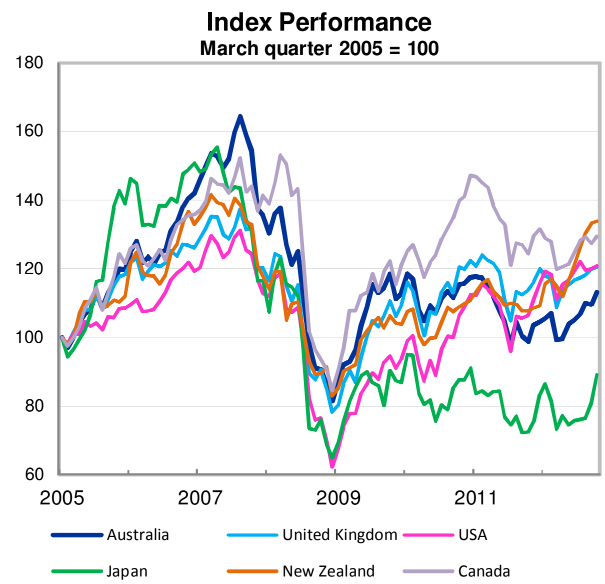
Sector Exposure - 31 Dec 2012



When it's all about China…

As Glenn Stevens, Governor of the Reserve Bank of Australia, noted mid last year in a speech entitled "The Lucky Country", Australia's economic performance during the turbulence of the last 5 years has been remarkably good[i]. Gross Domestic Product (GDP), a measure of the goods and services produced by an economy, has not taken a backward step. In the fiscal year ending June 2012 Australia's GDP was over AUD$1.47 trillion, an increase of over 36% from 2007 levels[ii]. That represents nominal economic growth of 6.4% pa, or 3.7% pa in real terms. It is forecast to grow even further to $1.53 trillion in FY13[iii]. By comparison, the performance of the Australian stock market has been considerably less remarkable.





Why have we been seemingly immune from the problems that have faced the rest of the world? What has caused our GDP to continue to rise in the face of slower economic growth around the world? Will the factors that have contributed to our strong growth continue to be supportive in the future? And what does this mean for equities? These are a few of the issues we have been considering recently.

Australia's GDP

GDP can be measured a number of ways, which should all lead to the same result. The most common approach is the expenditure method, which is the gross value of things purchased during the year. Every component of GDP has grown strongly between 2007 and 2012, the question is why.

Gross Domestic Product = Consumption + Investment + Government Spending + Exports – Imports

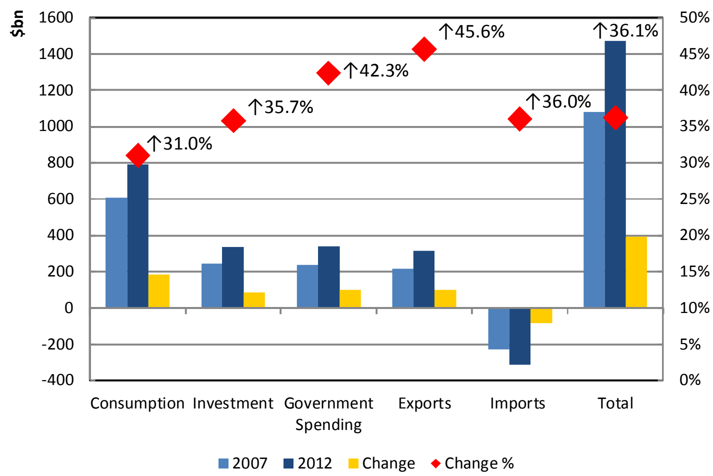
GDP ↑ 36.1% = C ↑ 31.0% + I ↑35.7% + G ↑42.3% + X ↑45.6% – M ↑36.0%

Note: All GDP data sourced from the Australian Bureau of Statistics.

Consumption

Consumption has risen the least, up 31%. This is not unexpected. Consumption growth is a function of aggregate income growth and the propensity to spend this income. Income growth has been moderate, except for the mining sector. The direct effect of the growth in earnings in the mining sector on total wage growth has been noticeable despite the sector employing only 2.0% of the Australian workforce. The indirect impact of the mining boom on wages in related industries is more difficult to measure although likely to also be meaningful. Total aggregate earnings have grown 35.2%, outpacing consumption growth. This is not surprising given the much publicised increase in the savings rate in recent years.

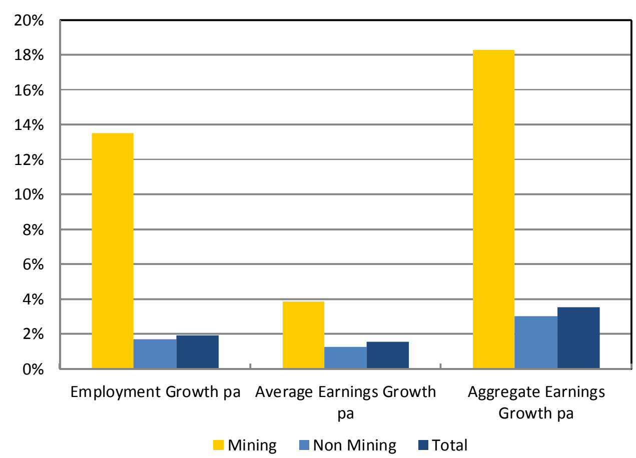
Change in GDP components: 2007 to 2012



Private investment

Private investment has risen strongly, up 35.7%. This has been almost entirely mining related. 87% of the increase in private investment between 2007 and 2012 has been in the mining sector. It should be noted the mining sector includes mineral solids, such as coal and ores, liquid minerals, such as crude petroleum, and gases, such as natural gas. This investment has by itself added 15% to GDP. And the RBA has predicted that investment in the mining sector will rise another 25% in FY13. The problem is that it will probably peak in 2013[iv] and it is unclear what will replace this mining investment. If nothing replaces it then what has been a boon for economic growth will become a significant drag on GDP in FY14 and beyond.

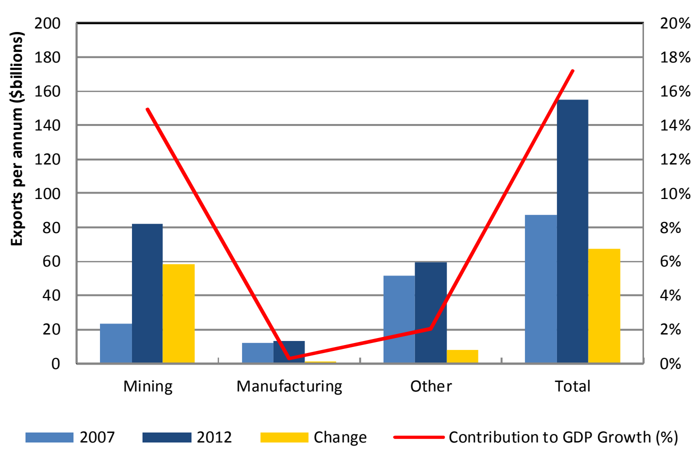
Income Growth drives Consumption



Government spending

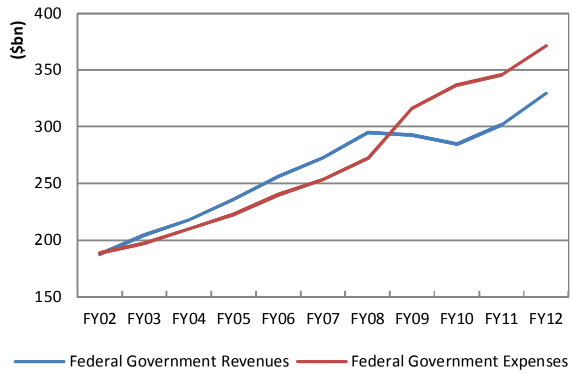
Government spending has risen 42.3%. Combine record Government revenues with record fiscal deficits and you get a $100bn boost to annual GDP. This increase in spending and investment has accounted for 23% of the total increase in GDP between 2007 and 2012.

Private Investment 2007 & 2012



The potential problem is that the record Government revenue has been driven by record commodity prices. Steep commodity supply curves indicate that prices will be extremely responsive to changes in supply. To that extent, Government revenue may actually fall as production levels increase. Even if commodity prices hold at these historically high levels there is unlikely to be significant Government spending growth in the next few years. The Federal Government has forecast a decline in Government expenditure in FY13. This would be negative for GDP growth.

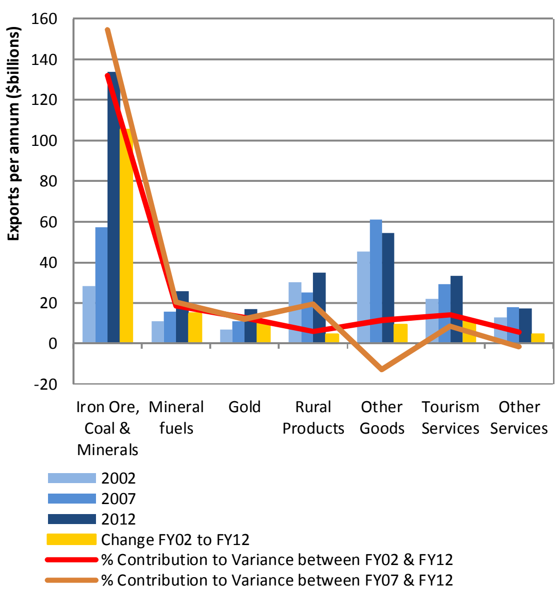
Federal Government Revenues v Expenses



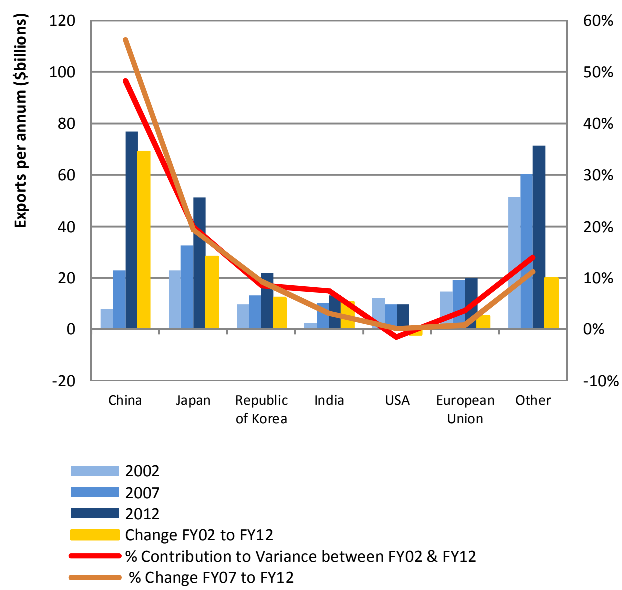
Exports

Exports have grown 45.6%, or $99bn. Mining related exports, including iron ore, coal, minerals and mineral fuels accounted for 87% of this rise, or 22% of the total increase in GDP over the 5 year period. The reason this is important is the potential for significant fluctuations in the demand for and price of these commodities over time. If we are at a high point in the pricing and demand cycle for certain commodities, then mean reversion in price, demand and supply will have a meaningful negative impact on Australia's export revenue and hence total GDP.

Australia's Key Exports



Australia's Export Destinations

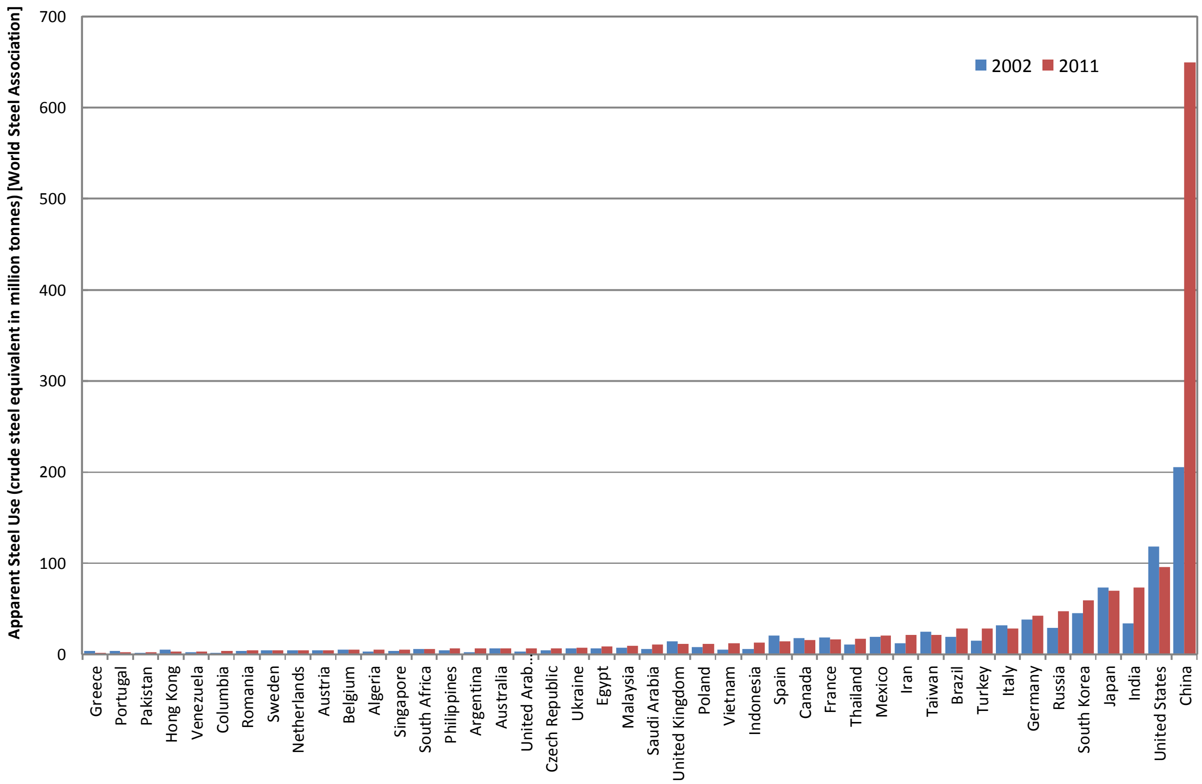


So where did the increased commodity demand come from? It was certainly not Europe or the US. In 2012 the entire European Union purchased just 8% of Australia's exports, the United States just 4%. Whatever happens in 2013, it is highly unlikely that either region will have a meaningful impact on the aggregate value of Australia's exports. By contrast, 85% of the increase in the value of our exports from 2007 to 2012 has come from China and countries that are exporting to China, namely Japan and the Republic of Korea, whose key export industries are predominantly steel intensive[v].

Do we know it is definitely demand from China and not other emerging markets increasing the value of our exports so significantly? Yes. Iron ore and coal are used in the production of steel. In 2011 China consumed 649.9mt of steel. The United States, whose consumption actually fell almost 20% over the decade, was second with 96mt. India was third with 74mt[vi].

In terms of steel, right now it's all about China.

Steel Use - 2002 vs 2011



Imports

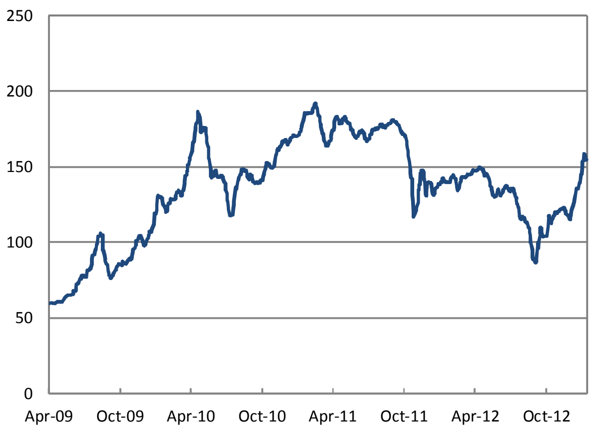
Imports are also up by 36%. It is worth noting that strong growth in imports has a negative impact on GDP growth.

Summary

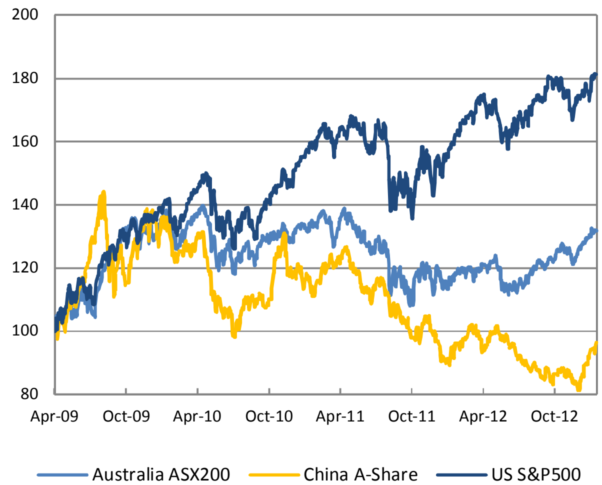
It is difficult not to conclude that Australia's strong economic performance over the last five years has been almost entirely the result of China's demand for our natural resources. This has led to a surge in exports and resource related investment. It has increased Government revenues which has allowed a surge in Government spending. It has fuelled significant growth in direct and indirect mining employment that has affected consumption. Australia's short term economic outlook therefore seems very much dependent on what happens in China in 2013 and beyond.

So forget Greece and the drachma. Australia could lose every dollar it earns in export revenue from Greece. It would be the equivalent of a move in the average annual iron price of about 8 cents. To put this in context, iron ore has had a $68 range over the past 6 months, with a low of $86.90 and a high of $158.50.

Iron Ore Price
From April 2009 (GFC low)



Relative Stock Market Performances
April 2009 (GFC low) = 100



From our perspective, our global macroeconomic focus is China, because what happens there will have a profound impact on the economic growth in Australia. While we have many thoughts on the likely growth trajectory and composition of economic growth in China going forward, we will save them for another time.

But what about equities? It is also worth remembering that the Australian stock market in the last few years has not reflected the strong economic growth that Australia has experienced. As at 31 December 2012 the Australian stock market was almost 10% below where it was 5 years prior. We would suggest that part of this is the market already aligning itself more with China's stockmarket than the indices in the US or Europe. This would make some sense. If the stockmarket is a lead indicator for the health of an economy then, given Australia's dependence on China's demand for its commodities, the direction of China's market may well be worth paying attention to. As the chart above would suggest, the Australian market already does.

We welcome any feedback or comments you have. Please direct them to info@auscapam.com.

[i] Glenn Stevens, Governor of the Reserve Bank of Australia, "The Lucky Country", Address to The Anika Foundation Luncheon, 24 July 2012, www.rba.gov.au
[ii] Australian Bureau of Statistics, 5206.0 – Australian National Accounts: National Income, Expenditure and Product, Sep 2012, www.abs.gov.au
[iii] Australian Federal Government Mid Year Economic and Fiscal Outlook domestic economy forecast, www.budget.gov.au
[iv] Glenn Stevens, Governor of the Reserve Bank of Australia, "Producing Prosperity", Address to the Committee for Economic Development of Australia (CEDA) Annual Dinner, 20 November 2012, www.rba.gov.au
[v] Key export industries include steel, automobiles, shipbuilding and machinery
[vi] India's steel demand would need to grow 10% to offset a 1% fall in Chinese steel demand, which is expected to be 700mt in 2012.