Auscap Long Short Australian Equities Fund Newsletter – January 2015

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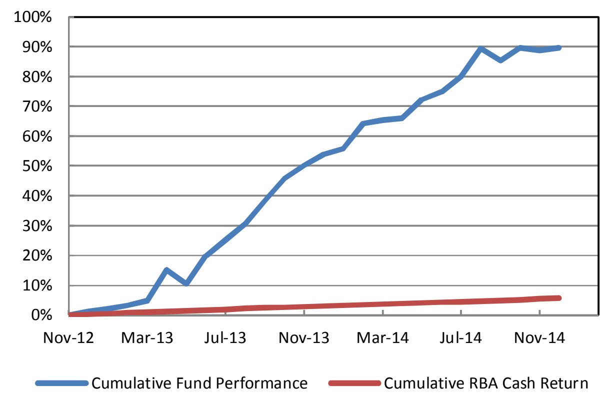
Welcome

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 discuss the relationship between price and value, providing a few thoughts on our value-based approach to investing.

Fund Performance

The Fund returned 0.44% net of fees during December 2014. This compares with the benchmark return of 0.21%. Average gross capital employed by the Fund was 141.1% long and 25.1% short. Average net exposure over the month was +116.0%. At the end of the month the Fund had 33 long positions and 5 short positions. The Fund's biggest stock exposures at month end were spread across the financials, consumer discretionary, healthcare, telecommunications and industrials sectors.



Fund Returns

Period	Auscap	Benchmark
December 2014	0.44%	0.21%
Financial Year to date	8.48%	1.25%
Calendar Year to date	23.18%	2.51%
Since inception	89.63%	5.63%

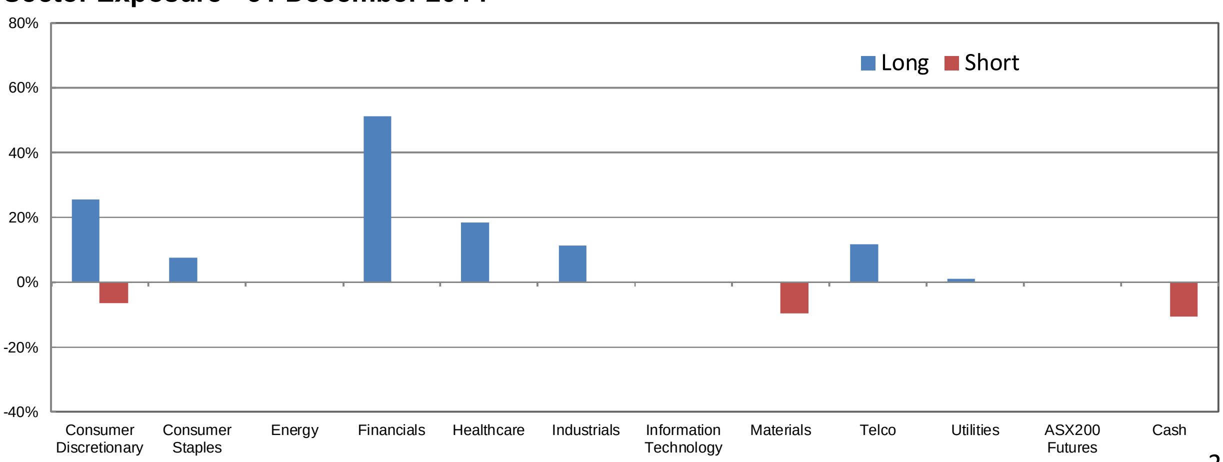
Fund Exposure

December 2014 Average	% NAV	Positions
Gross Long	141.1%	34
Gross Short	25.1%	10
Gross Total	166.2%	44
Net / Beta Adjusted Net	116.0%	89.8%

Fund Monthly Returns

Year	Jul %	Aug %	Sep %	Oct %	Nov %	Dec %	Jan %	Feb %	Mar %	Apr %	May %	Jun %	YTD
FY13						1.35	0.74	1.23	1.46	9.83	(4.05)	8.32	19.72
FY14	4.70	4.28	5.84	5.46	2.86	2.57	1.32	5.32	0.70	0.29	3.82	1.48	46.01
FY15	2.95	5.24	(2.09)	2.25	(0.43)	0.44							8.48

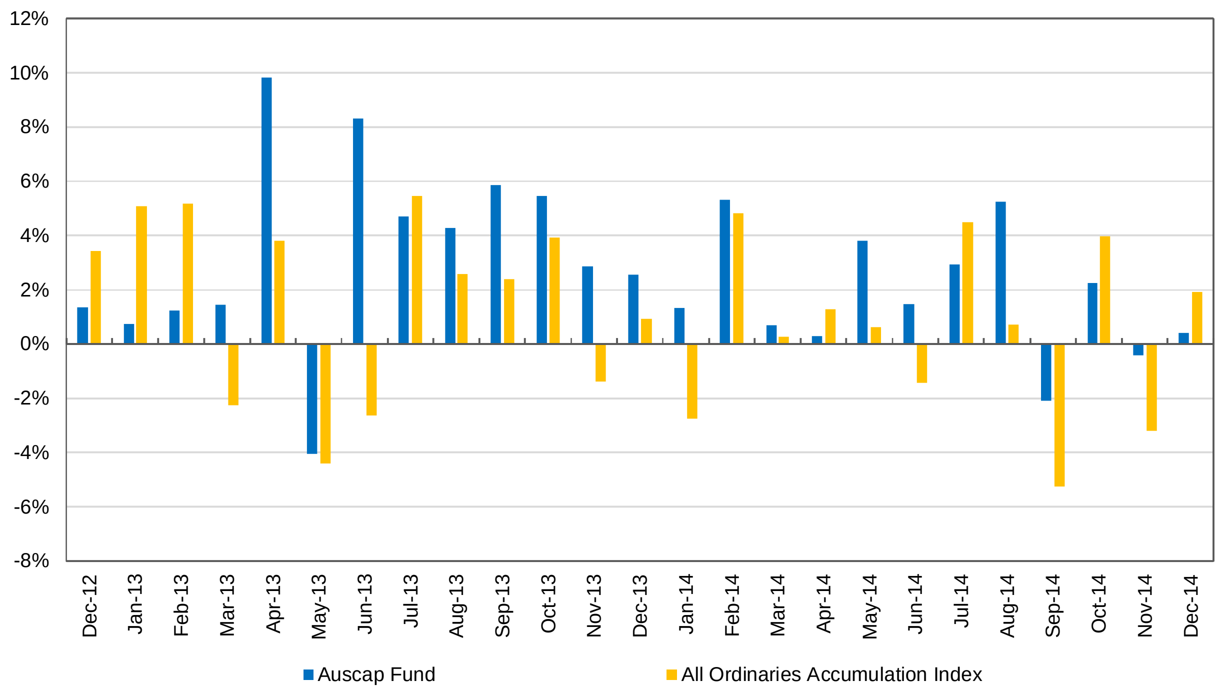
Sector Exposure - 31 December 2014



Simple Logic For The Value Investor

2014 was a strong year for the Auscap Long Short Australian Equities Fund, which returned 23.18% post-fees in the calendar year. This compares with the All Ordinaries Accumulation Index return of 5.02% and the Dow Jones Credit Suisse Long Short Equity Fund Index return of 5.55%. While we were pleased with this return it is worth noting that we have considerably lower return expectations for both the Fund and individual positions. Therefore we do not encourage any extrapolation of these and prior results. The Fund's volatility for the year of 7.8% was also lower than the 11.0% for the market. The Fund's monthly returns, compared with the monthly returns of the All Ordinaries Accumulation Index since inception, are featured below.

Auscap Long Short Australian Equities Fund - Monthly Performance



While the historical return profile of a Fund is worth considering in any investment decision, we also think it is important for our current and prospective unitholders to understand our approach to investing. Our aim is to have an investor base who are comfortable with our approach. Managers operate based on their core investment beliefs. For this reason we spend considerable time in the newsletters discussing our value-based approach.

Recently we were reminded of an equation that describes the price of a security in straightforward terms:

$$P = E \times P/E$$

In other words, price equals earnings times the price to earnings multiple the market is willing to pay for those earnings. Clearly if you divide both sides by E or P one can see that such a statement is correct. But perhaps more interestingly, it demonstrates that price can be affected by *either* changes in earnings *or* changes in the price to earnings ratio. Quite often one can find a great company and be reasonably certain that the company will increase earnings over the short to medium term, perhaps even over the foreseeable future. But is it enough to find a great company? Does a great company make a great investment?

From our perspective, a great investment is finding a company at a great price, rather than finding a great company at any price. Indeed a great investment need not be a great company. As long as it meets our basic requirements for generating cash and meeting our return on capital hurdles, a reasonable company purchased at an extremely attractive price seems far more likely to generate attractive returns than a great company purchased at an inflated price.

If price is a function of two components, the earnings of the company and the multiple of earnings that the company trades on in the market, then a good investment needs not only to have stable and growing earnings, but also an attractive entry price. We look for companies that, over time, should increase earnings (the “E”), with relatively low risk around the potential for deflation of the multiple that we are paying for those earnings (the “P/E”) on acquisition. Ideally we like to find opportunities where we see upside in both the earnings and the multiple the market might pay over time for those earnings.

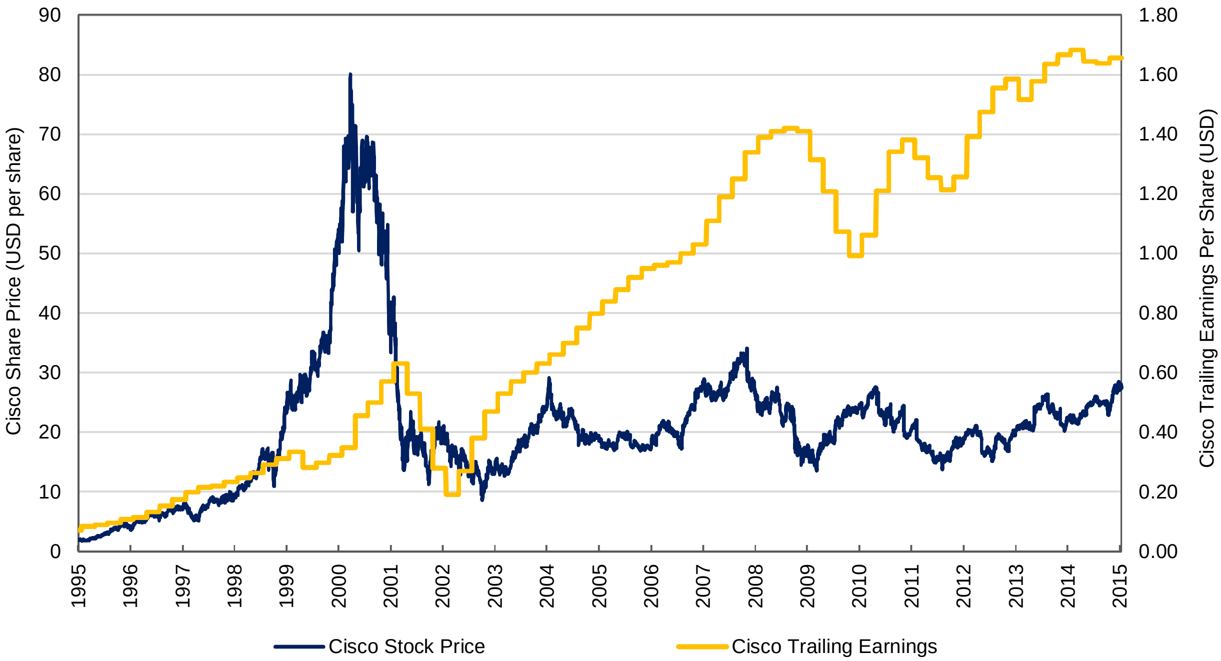
Finding a great company and paying the market price seems to us to be fraught with risk. You might be very confident in the earnings growth of the business, but what happens if the multiple declines as the earnings growth slows or the market simply decides to pay less for those earnings? In this case one can be entirely correct about the earnings, but lose money on the investment if the decline in the multiple more than offsets the increase in earnings. History is replete with examples where investors bought good companies at high prices, only to suffer loss of capital.

The Nifty Fifty, for example, were the “must own” companies in the US in the 1960s and 1970s. They were 50 large capitalisation stocks on the New York Stock Exchange that were popular due to their size and the quality of the companies. Many of these companies are still significant companies today. The list included The Coca-Cola Company, Dow Chemical, General Electric, IBM, Johnson & Johnson, McDonalds, Pfizer and Procter & Gamble. Each one of these companies today generates at least $25bn in annual sales. As it became the consensus view to own the Nifty Fifty during the late 1960s and early 1970s many stocks traded on north of 50x earnings. Unfortunately, during the bear market of the 1970s most of these stocks declined to single digit multiples, under-performing the broader market indices and proving terrible investments.

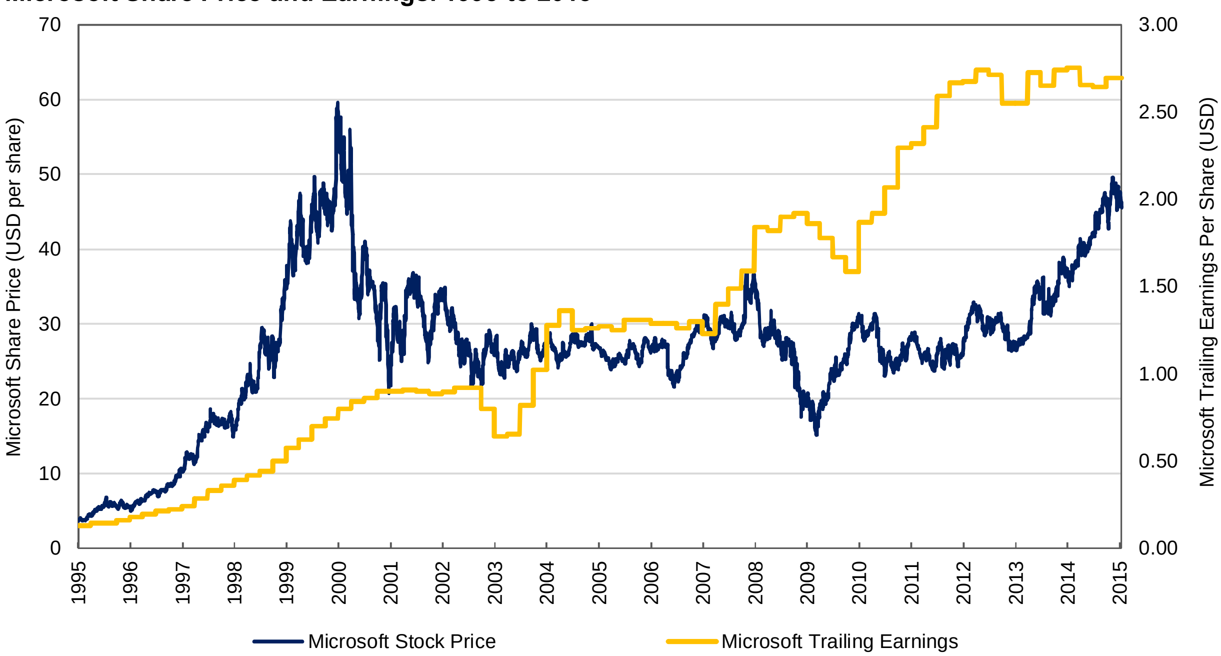
The Coca Cola Company Share Price: 1968 to 1980

More recently, investors might remember the internet bubble of the late 1990s, where euphoria around the potential impact of the technological revolution drove the stock prices of all things dotcom to spectacular multiples. Most of these companies declined in excess of 80% in the bust that followed. Some of these companies, like Cisco and Microsoft, remain strong companies with very significant and growing earnings, and yet they have still not surpassed their 1999-2000 highs despite their earnings increasing 513% and 337% respectively over the fifteen year period from 1999 to 2014. Our conclusion is that great companies trading at high prices can make poor investments.

Cisco Share Price and Earnings: 1995 to 2015



Microsoft Share Price and Earnings: 1995 to 2015



While it might seem obvious to buy businesses that have earnings growth and trade on low multiples, there are typically few companies that display such characteristics. Normally companies with strong growth are priced on fair to above fair multiples. Similarly, companies trading on cheap multiples are often displaying weak or potentially negative near term growth. Indeed the vast majority of the market appears highly efficient most of the time. An efficient market by definition will not afford investors the opportunity for stronger-than-market returns.

In assessing any company we take a medium term view and understand where our estimates differ from the consensus. Securities are on occasion priced attractively because the near term outlook may appear challenging even if the medium term prospects are stable to strong. This is where the patient investor has an advantage and can purchase the securities when they are attractively priced and wait for earnings to gradually improve.

Any assessment of a company's outlook is, to an extent, subjective. It is far easier to assess the current year's earnings than future earnings, where the economic, competitive and technological environment might differ dramatically from today's environment. As value investors we prefer paying for a dollar of earnings today than a dollar of future potential earnings.

As Howard Marks, principal of the distressed debt fund manager Oaktree Capital Management, observed:

> "*Value investors buy stocks (even those whose intrinsic value may show little growth in the future) out of conviction that the current value is high relative to the current price.*
>
> *Growth investors buy stocks (even those whose current value is low relative to their current price) because they believe the value will grow fast enough in the future to produce substantial appreciation.*
>
> *Thus, it seems to me, the choice isn't really between value and growth, but between value today and value tomorrow.*"

Howard Marks, Oaktree Client Letter, "The Happy Medium", 20 July 2004

We certainly favour stocks where the bulk of our valuation comes from value today and where relatively conservative assumptions around future profitability and growth will provide our investors with a satisfactory return on their capital. We find it nearly impossible to predict future significant multi-year growth and to rely on such forecasts as the basis for investment decisions. Without conviction in your assumptions, we believe it is difficult to hold positions in testing times. Bullish assumptions also frequently appear to have a negative skew, with upside surprises less common than downside surprises in both number and proportion. All of which leaves us uncomfortable about making bold predictions to justify valuations.

We would add to this that we find value is rarely found where there is a consensus of opinion. If there is a consensus viewpoint, everyone who might purchase a security probably already has. Inevitably the stock is trading at a full price. The marginal buyer is non-existent because everyone who would own the security does own the security. Indeed it is at these times that the prospect of respectable future returns is quite low. Ironically, in our experience this is often when the outlook for the company appears impenetrably strong. These tend to be occasions when the consensus view frequently turns out to be incorrect in its assumptions or, just as likely, circumstances change rendering valuations factoring in strong future growth obsolete. This presents a real risk of permanent loss of capital.

With any investment we believe the most important relationship is the one between the price you pay and the value you receive in exchange. A value-based manager lives according to the adage "a bird in the hand is worth two in the bush". We prefer paying conservative prices for good companies that will deliver an acceptable total return through current income and modest growth over time. If we can find sufficient companies with these characteristics over time we believe we should deliver our investors satisfactory risk-adjusted returns.

If you do not currently receive the Auscap Newsletter automatically, we invite you to register. To register please go to the website www.auscapam.com and follow the registration link on the home page. Interested wholesale investors can download a copy of the Auscap Long Short Australian Equities Fund Information Memorandum at www.auscapam.com/information-memorandum. We welcome any feedback, comments or enquiries. Please direct them to info@auscapam.com.

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