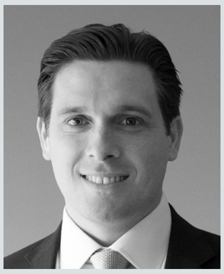

01:
Tim Carleton
portfolio manager,
Auscap Long Short
Australian Equities
Fund

Investing in the sweet spot

The Auscap Long Short Australian Equities Fund identifies compelling opportunities in undervalued companies through a patient and value-based investment approach that produces solid absolute risk-adjusted returns.

The portfolio managers behind Auscap Asset Management's flagship fund never aim to be the smartest people in the room. Yet the pairing of Tim Carleton [01] and Matthew Parker has proven to be a clever one.

The Auscap Long Short Australian Equities Fund has delivered annualised returns of about 27% since its inception in 2012, returning more than 160% net of fees to initial investors.

As Carleton explains, the results have come from a disciplined, patient and value-based investment approach that attempts to minimise mistakes.

"We are quite risk averse managers. We typically invest in companies that most people are familiar with and that are growing cash profits steadily but not necessarily spectacularly over time," Carleton says.

"We look for lower-than-market risk 10 to 15% return opportunities. If the fund managed these sort of returns over time we would be delighted. We are certainly not trying to do 25% or 30% a year and would discourage investors who are looking for those sorts of returns from coming into the fund."

Being a value-based manager means Auscap looks for assets trading at prices that are below its view of the fair value or intrinsic value of the company.

As a long short fund the firm holds long positions like all sharemarket investors. These are small ownership stakes in Australian companies that Auscap thinks will appreciate in value over time. The short positions hope to benefit from falls in the share prices of Australian companies that Auscap thinks are significantly overvalued. Having the ability to short is a defining feature of the fund compared to a long only managed fund or a typical retail investor portfolio.

Carleton says the search for assets that are undervalued on the ASX does not mean the firm targets cheap companies. He reiterates the focus is on undervalued companies that are also good businesses, which must have several key attributes:

- The ability to generate strong cash flows – Auscap focuses on cash flows rather than accounting profits;
- A sensible balance sheet that isn't overly leveraged;
- A track record for strong returns on invested capital – in other words, when a company invests $1 million in a piece of machinery they generate strong returns from that investment;
- A simple business model – where management can explain how the company makes money on the back of a business card, because most good businesses have simple business models; and
- A sustainable competitive advantage – the company has an edge over their competitors, meaning they should be able to continue to generate good profits into the future.

"Waiting until you see attractive opportunities can require a lot of research without a lot of investing activity. Having the patience to wait for compelling opportunities is a critical part of the value investment process," Carleton says.

Sector biases

The fund is relatively sector agnostic when it comes to analysing investment opportunities, provided the company has the attributes discussed above. Carleton says some sectors will have more companies that meet Auscap's criteria and it tends to result in sector biases within the portfolio. As an example, historically there have been many retail stocks who share the right attributes.

"The retailers have generated significant cash flows and had a great return on capital, so we have had a reasonable exposure to that sector," Carleton says.

"By contrast, very few energy companies have delivered decent returns on invested capital, despite the commodity boom we have had. Our exposure to energy has historically therefore been quite low."

Auscap also has a large bias towards companies that sell products or services the portfolio managers are familiar with and typically customers of.

"We don't like investing in complicated businesses that are selling specialised products because we find that we have a huge information disadvantage," Carleton says.

As an example Auscap does not have anyone in the investment team with a background in biomedical scientific research, and as a result, it won't invest in the biotech sector.

The short angle

The portfolio manager explains that Auscap has the ability to short stocks – meaning it can sell a stock it has borrowed from another institution and subsequently repurchase the shares at a later point in time.

The quote

Having the patience to wait for compelling opportunities is a critical part of the value investment process.

Watch the video
on www.fsitv.com

The lending institution collects a fee they otherwise wouldn't receive; the short seller [Auscap] benefits if it's right in its view that the stock price will fall allowing them to buy it back at a lower price. The flipside, Carleton explains, is that the fund can lose money if the stock goes up and Auscap has to buy it back at a higher price.

"Short selling benefits the fund in two ways. Firstly, if we are more right than wrong then the shorts will add to our total return, as they have for the fund to date. Secondly, it means that the fund isn't as volatile in down markets as it otherwise would be," Carleton says."

Since the fund started, in the months when the market has been down, the market has, on average, been down 2.8%. In those same months the fund has, on average, been up 0.4%.

"Much of the reason for the outperformance is the contribution of the shorts which have been profitable in months when our long positions are declining. So short selling can provide a bit of a hedge, not a perfect hedge, but some protection from falling markets," Carleton explains.

Where does the fund fit in portfolios?

Auscap believes its Long Short Australian Equities Fund can complement many Australian investors' normal share portfolio. As most investors are heavily invested in the top 12 companies, which constitute half of the All Ordinaries by market capitalisation, the Auscap fund offers exposure to other large and mid-cap stocks.

Recent Auscap analysis showed that over the first four years of the fund's operations, its average net exposure (longs minus shorts) to the ASX top 12 was approximately zero. Yet 80% of the fund's returns in FY16 came from ASX100 stocks.

"So our sweet spot is really ASX listed companies from 13 to 150, which is where most investors are underweight. And there are some really great companies in that range that already generate lots of cash today that will continue to grow in the future," he says.

"When people realise that they should diversify, they often think this involves going and buying a handful of small caps that actually need a lot of monitoring and attention."

Auscap produces a monthly newsletter to share its investment philosophy and market views. Signing up is free by heading to www.auscapam.com and providing an email address. **FS**