DAILY CLASS

Long Short Fund

Quarterly Report | March 2018

Redemption price: 1.2461[1,2] | **Fund NAV:** $1,094m

March 2018 Quarter

- **The L1 Capital Long Short Fund returned -1.6% for the quarter, taking the net return over the past 12 months to 19.7%.**
- **The Fund has returned 33.3% p.a. taking the total return to 180.2% since inception (after fees).**
- **The Fund has achieved outstanding risk-adjusted returns (maximum drawdown 2.4%, sharpe ratio 3.7, sortino ratio 19.8).**

Global equity markets experienced a spike in volatility in February and into March, with the S&P/ASX200 Accumulation Index (ASX200AI) falling 3.9% in the quarter. In Australia, sector performance diverged dramatically with Health Care (+6.9%) and Information Technology (+1.6%) the standouts, while Telcos were once again the weakest sector (-11.0%), having lost a quarter of their value over the past year. Banks (-7.1%) sold off heavily on the back of the Royal Commission, with Utilities (-6.9%), Energy (-6.6%) and REITs (-6.4%) the other laggards.

The Fund's performance benefited from short positions in the technology, property and materials sectors. The Fund's worst sector over the quarter was its long exposure to European financials, which suffered with the hung parliament from the Italian elections and the broad sell off and risk-off environment. We believe our exposure to European financials is an attractive medium-term position, given all of our stocks are trading in-line or below book value, offer strong upside from any increase in bond yields and are very well capitalised, offering the potential for strongly rising dividends and/or buybacks.

In this report, we discuss the growing dispersion between high P/E and low P/E stocks and the opportunities this backdrop is creating. We also discuss the increasing risks in the technology sector, which now appears very overvalued, with a number of significant headwinds beginning to emerge simultaneously. We also highlight the growing risks to the macro environment from rising U.S. inflation.

Monthly Net Performance (%)*

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT*	NOV	DEC	YTD
2014	–	–	–	–	–	–	–	–	(2.42)	3.03	2.85	1.61	**5.07**
2015	0.59	9.14	2.42	1.71	3.73	(0.86)	3.30	2.06	5.51	8.49	8.11	4.62	**60.52**
2016	5.81	0.59	5.47	2.46	2.78	(0.89)	3.22	3.92	0.46	(0.18)*	0.55	2.13	**29.43**
2017	2.48	1.79	2.83	1.01	4.14	1.68	2.61	1.67	1.91	2.50	0.86	3.50	**30.50**
2018	0.54	(0.49)	(1.68)										**(1.63)**

Past performance should not be taken as an indicator of future performance.

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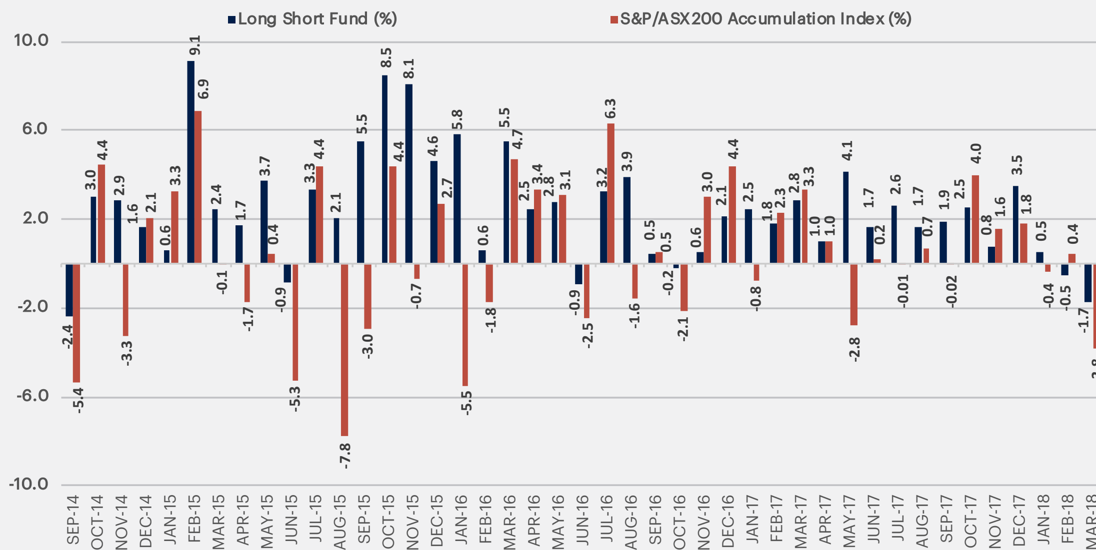
Performance Summary

Performance Metrics (%)*	
One month	**(1.68)**
Three months (rolling)	**(1.63)**
Financial YTD	**11.90**
One year	**19.69**
Two years (p.a.)	**21.66**
Three years (p.a.)	**33.37**
Since inception (p.a.)	**33.32**
Since inception (cumulative)	**180.25**

Monthly Fund Performance vs S&P/ASX200 Accumulation Index (since inception)*



All figures are net returns as at 31 March 2018. *Fund inception 1 September, 2014

- True alpha generation. 173% of the net return has been alpha (only 7% from beta)
- Extremely strong capital preservation (stronger returns than market in **every** market sell-off)
- Market has fallen more than 1% in 13 individual months. Fund has been down by more than 1% on two occasions
- Very low correlation with equity markets

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Portfolio Attribution (Since inception*)

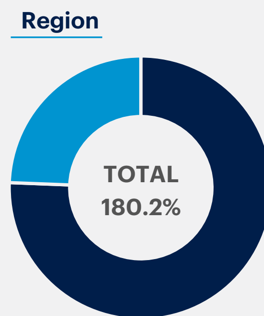
Total Returns (since inception)*	
L1 Capital Long Short Fund (net)	**180.2%**
S&P / ASX200 Accumulation Index	**20.2%**
MSCI World Index	**28.4%**
HFRX Global Hedge Fund Index	**1.1%**

Market Cap

Over $1b **126.6%**

Sub $1b **53.6%**

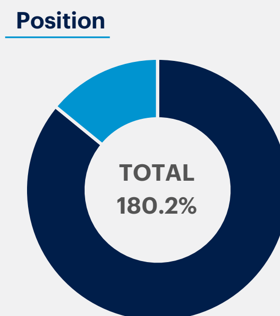
Region



Australia **137.9%**

International **42.3%**

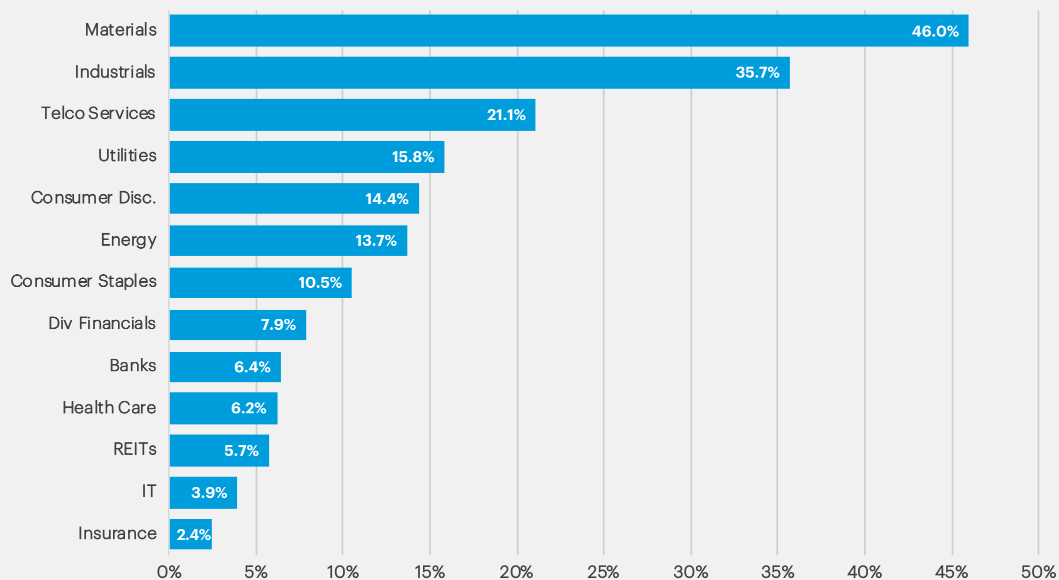
Position



Long **153.9%**

Short **26.3%**

Strong positive returns across every sector



Note: Data presented above excludes portfolio hedges (eg. Short Index Futures & FX hedging) which detracted from performance .
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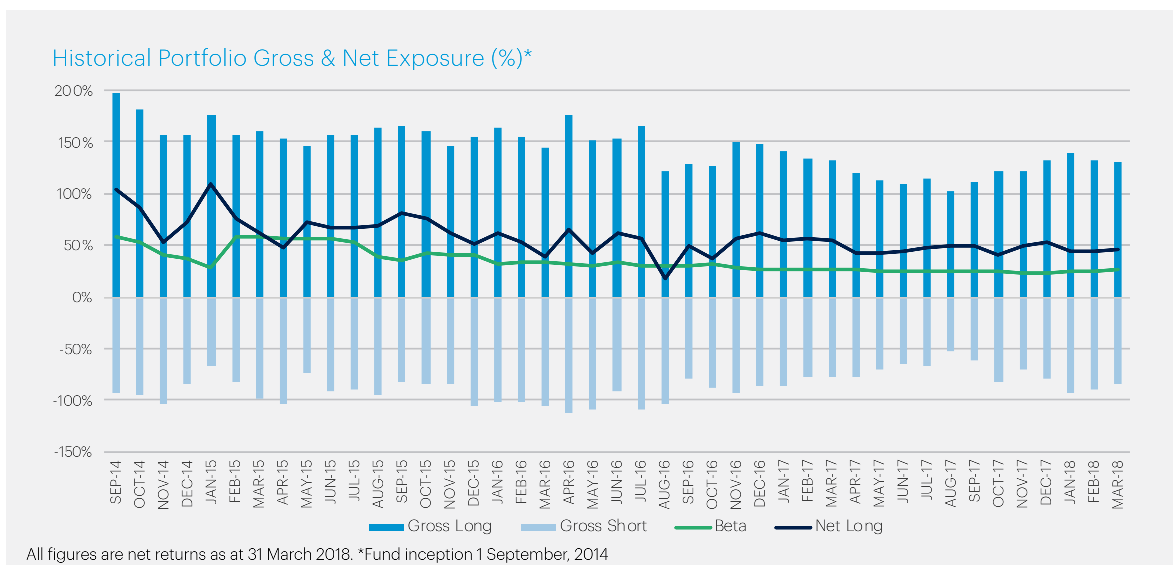
Fund Analytics and Exposures

Fund Characteristics*	CURRENT	AVG SINCE INCEPTION
Number of positions	**93**	**74**
Number of long positions	**56**	**50**
Number of short positions	**37**	**24**
Gross long exposure (%)	**130%**	**145%**
Gross short exposure (%)	**84%**	**87%**
Gross exposure (%)	**213%**	**232%**
Net exposure (%)	**46%**	**58%**

Risk Metrics*	LONG SHORT FUND
Beta	**0.27**
Sharpe ratio	**3.7**
Sortino ratio	**19.8**
Maximum drawdown	**2.4%**
% positive months	**86.0%**
Annualised standard deviation (%)	**8.5%**
Annualised downside deviation (%)	**1.7%**



All figures are net returns as at 31 March 2018. *Fund inception 1 September, 2014

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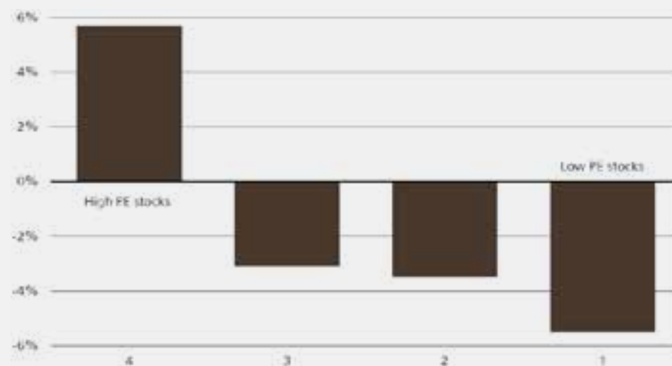
Current Portfolio & Market Overview

One of the clearest trends we've observed so far in 2018 has been the bifurcated nature of the market, where high P/E stocks that offer strong earnings growth and have a high level of earnings certainty are being bid to higher and higher levels, while low P/E stocks that have weaker earnings growth and less earnings certainty continue to lag significantly. As you can see in Chart 1, the average 'high P/E' stock has already outperformed the average 'low P/E' stock by more than 10% so far this year. The typical investor that buys high P/E stocks tends to be 'growth' funds, momentum/quant strategies, or ETFs that often skew to 'hot' sectors. Risk averse investors may want to invest in companies that are performing strongly now, as opposed to betting on a turnaround or break up story. The aggregate buying demand from these discrete groups is huge and often results in 'market darlings' overshooting to the upside, while the company continues to perform well.

Most sectors in Australia are now trading at P/E multiples well above their long-term average (see Chart 2). Some of the most extreme re-ratings have been seen in Healthcare, Consumer Staples, Media, Gaming and Diversified Financials. Unsurprisingly, the sectors that are now trading 'cheap' versus their long term average are Telcos, Energy, Steel and Banks.

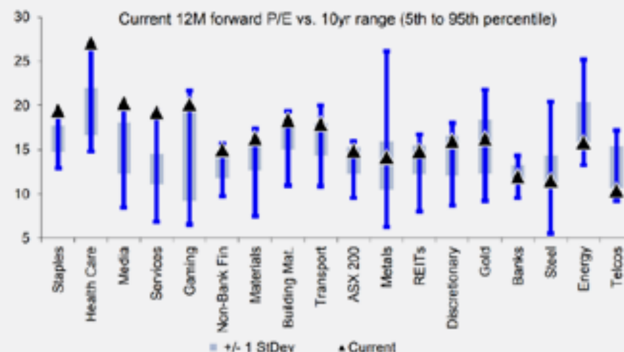
The current portfolio is showing some of the largest valuation dispersion between the long and short positions since inception. Across most metrics (P/E, EV/EBITDA, etc) our short portfolio is trading at multiples that are 30-70% more expensive than our long portfolio. For example, the FY19 EV/EBITDA for our longs is around 7x versus 12x for our shorts. The median FY19 P/E for our longs is 13x versus 17x for our shorts. Compared to our shorts, our longs have far stronger balance sheets, higher and faster growing dividend yields and faster EPS growth. While we are comforted in a medium-term sense that our portfolio has very attractive attributes, we remind investors that shareprice performance does not arrive instantly or in a smooth, linear fashion.

Chart 1: Performance by P/E quartile so far in calendar year 2018 (ASX 100 ex-resources)



Source: Factset, UBS, weighted by market cap as of 31 December 2017.

Chart 2: Sector 12-month forward P/E vs. 10-year range



Source: Factset, I/B/E/S, Bloomberg

Technology Sector – The bull is getting old

The technology sector has enjoyed an epic bull run since the market lows of early 2009. The emerging dominance of companies like Apple, Google and Facebook has turbocharged the NASDAQ Index, which has risen a staggering 450% over the past nine years. For the first time ever, the five largest stocks in the U.S. are now all technology companies, with an average market cap of close to one trillion dollars each (US$700b). These five companies - Apple, Google, Microsoft, Amazon, Facebook – are all incredibly dominant, unregulated businesses that have a loyal following of billions of consumers globally who rely on these products & services every day.

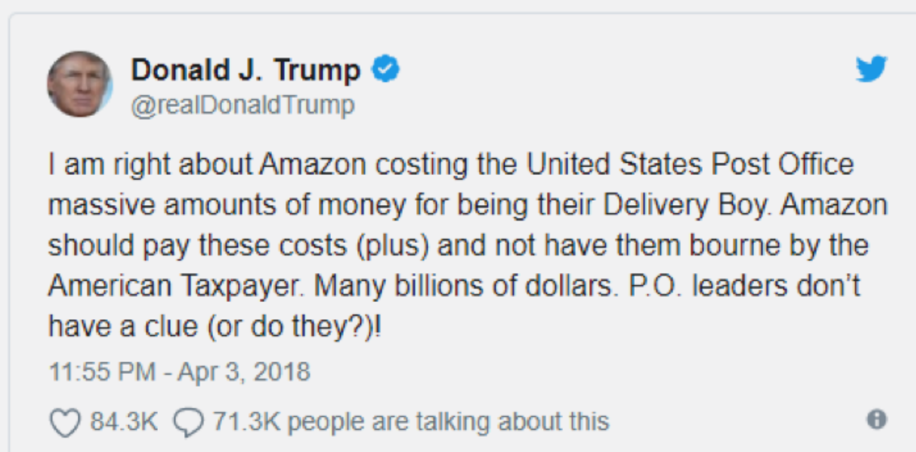
The surge in these stocks has created a second layer of high growth technology companies that are all trying to become "the next big thing". Venture capital firms have flooded the world with capital for tech start-ups. Furthermore, retail and institutional investors are increasingly desperate to invest in these emerging companies that offer fast growth and the hope of finding the next Facebook/Google.

Our belief is that the enormous uninterrupted bull run in technology stocks is now at a risky juncture, particularly for second tier companies, where a series of risks are appearing simultaneously.

Regulatory Threats

Up until recently, some of the largest technology stocks have been able to operate essentially as unregulated monopolies. Over time, consumers, businesses and Governments have all grown increasingly frustrated by the enormous power of these tech giants and their ability to destroy smaller competitors, avoid paying their fair share of taxes and control vast amounts of personal user information (not to mention, influence election outcomes). This festering resentment has manifested in Google facing multi-billion dollar fines in Europe, Amazon being on the receiving end of criticism from President Trump via twitter and Facebook's Founder & CEO, Mark Zuckerberg, facing hours of interrogation from the U.S. Senate as a result of the Cambridge Analytica scandal. The ultimate impact of this regulatory scrutiny is unknown, but presents only downside risk versus the status quo. Given the rise of populism globally, we believe the risk of a punitive political backlash is growing. Influential political figures on both the left and right, such as Bernie Sanders and Steve Bannon, are calling for big technology stocks to become regulated like utilities or broken up.

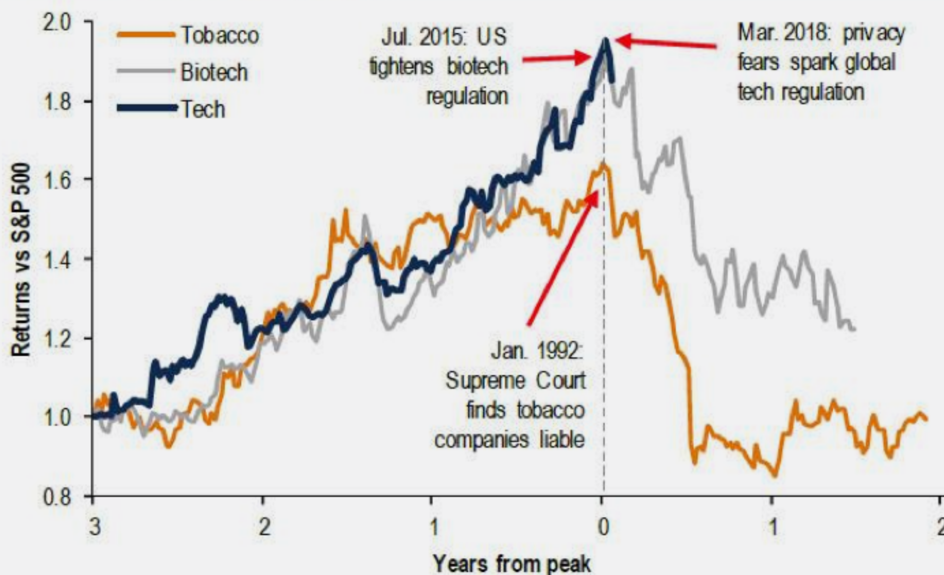
Chart 3: President Trump weighing into the debate



Source: Twitter.

Technology Sector – The bull is getting old (continued)

Chart. 4: Equity bubbles popped by regulation



Source: BofAML Global Investment Strategy, Global Financial Data, Bloomberg
'Tech' = US Information technology + Internet Retail

Aggressive accounting

We believe many technology companies are now producing financial accounts that overstate their true performance due to their consistent use of "non-GAAP" earnings (GAAP stands for 'Generally Accepted Accounting Principles'). This means that the company's stated earnings are not consistent with accounting principles that have been widely accepted by the accounting standards board as appropriate for companies to use to provide a fair assessment of their underlying financial performance and position.

One major difference between GAAP and non-GAAP earnings relates to expensing of share issuance and stock options. Technology firms extensively use share-based remuneration, hence impacting the headline multiples at which the stock trades.

Lastly, R&D expenses are all too often capitalised, with the explanation that the investment being made is "one-off" in nature and has a delayed benefit, so the R&D should match that profile. In reality, most technology firms need to invest in R&D every year just to maintain their business (and therefore a higher amount should be expensed in the year it is incurred).

Evangelical CEOs

The frothiness in technology stocks has been enhanced by a raft of ultra-optimistic and often misleading CEOs who dramatically overstate the company's competitive position and addressable market. All too often we now hear CEOs describe their technology as "disruptive", "revolutionary" or "best in class" and all too often our research leads us to the conclusion that this is not the case. Another common approach is for the CEO to describe a massive "TAM' (Total Addressable Market) that dramatically overstates the true addressable opportunity. The analogy would be opening a café and saying that there are 2.2 billion cups of coffee sold every day, so that is the Total Addressable Market. The reality is obviously dramatically smaller. While this issue of overhyping the opportunity is most acute across the second tier of tech stocks listed on NASDAQ, Australia has had its own recent examples, such as former high fliers, 1-Page and Getswift.

Technology Sector – The bull is getting old (continued)

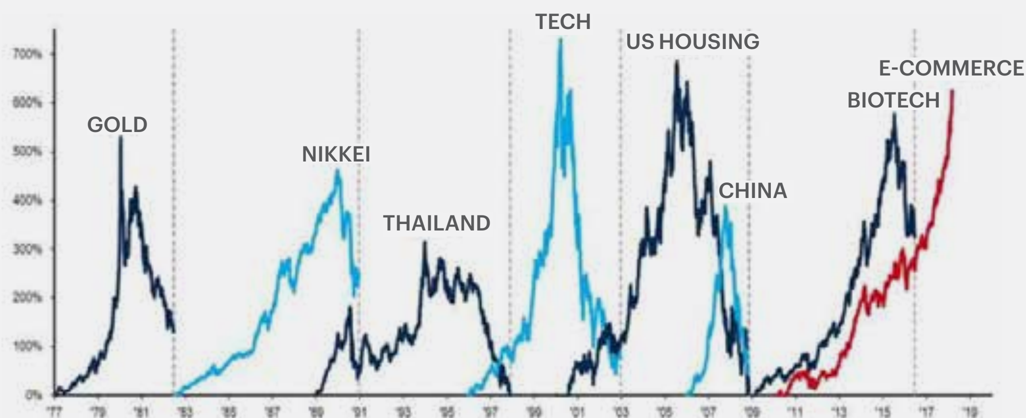
Unusual Valuation Techniques

Recently, many brokers have begun using Price to Sales as the standard method for valuing technology stocks (given that most have little/no earnings). The theory is that because these companies are growing fast and (claim to be) reinvesting for growth, a Price to Sales metric normalises for that reinvestment. That may be true for the occasional company, such as Amazon, however the use of Price to Sales multiples has become pervasive and has become the most used metric for all SAAS, big data, internet security and artificial intelligence stocks. All too often these firms have not demonstrated any operating leverage, with losses persisting or even growing despite the claimed 90%+ incremental margins.

We've also been astounded by the valuations that are now being ascribed to some 'early stage concepts' that have not been commercialised. One notable example, is the US$20 billion valuation that is ascribed to Tesla's autonomous fleet (ie. imagine Uber without the need for drivers). While Telsa does have an autonomous fleet programme that it is currently trialling, very few jurisdictions globally allow these cars to operate. In the trials thus far, a Tesla driver died after colliding with a highway barrier and an Uber self-driving vehicle hit and killed a pedestrian walking her bike. While Tesla's Model S includes an "autopilot system", it is deemed not suitable for urban driving as it is unable to detect pedestrians or cyclists. While autonomous vehicles may one day become safe and reliable enough to gain widespread adoption, a US$20b valuation to a player who has yet to even develop a pilot product that can operate in city driving appears far too optimistic.

Bank of America recently showed a chart of the price performance of the Dow Jones eCommerce Index (DJECOM) and contrasted it with a number of price bubbles over the past 40 years (see Chart 5). While the size and trajectory of the eCommerce rally is consistent with previous bubbles, this rally has largely been driven by impressive companies with strong earnings and cashflows and dominant business models. The 'bubble' element appears to be confined far more so to the second tier of technology stocks that have enjoyed the halo effect from a sector re-rating that resulted from the success of truly disruptive companies like Amazon, Netflix and Facebook.

Chart 5: Asset price bubbles of the previous 40 years



Source: B0fAMLGlobal Investment Strategy, Bloomberg; Note Gold (XAU Curncy), Japanese Equities (NKY Index), Thai Equities (SET Index), Tech (NDX Index), US Housing (SSHOME Index), Commodities (SHCOMP Index), Biotech (NBI index), e-Commerce (DJECOM Index).

Technology Sector – The bull is getting old (continued)

In the Fund, we are short a number of overhyped technology stocks, where we believe the hype from management and broker commentary dramatically overstates the likely cashflow generation of the business long term and the supposed dominance of the company is likely to be disproved in the coming years.

As an interesting data point, the performance of the NASDAQ has mirrored that of high yield credit. Both have been beneficiaries of massive monetary stimulus and growing risk appetite from investors.

Chart 6: NASDAQ index vs US high yield / investment grade total returns

Source: BofAML Global Investment Strategy, Bloomberg

Global macro – Inflationary pressures building

Over the quarter, we reviewed hundreds of charts and tables of data. The following six charts highlight some of the most important themes and risks that we see in equity markets at present:

(i) Producer Prices

There is a clear and consistent increase in U.S. producer prices that should flow through to consumer prices. The ongoing increases in oil and commodity prices suggest these increases will persist (at least in the short term).

The U.S. employment market is now very tight. You need to go back 20 years to find another time where it has been so hard to fill a job vacancy.

Chart 7:: US PPI (year-on-year)

Source: Wall Street Journal

Chart 8:: NFIB: Job openings hard to fill

Source: NFIB, Wall Street Journal.

Global macro – Inflationary pressures building (continued)

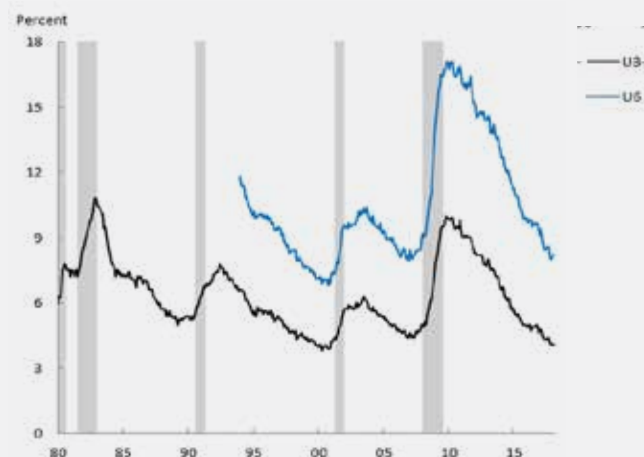
The result of having such a tight labour market, is that wages pressure is now becoming evident and will likely persist, given monetary policy and now fiscal policy remains very expansionary.

Most investors assess the current low level of unemployment in the U.S. as an unequivocal positive for the stockmarket. While that is true as a 'point in time' assessment, it ignores the secondary effect of strong employment. As you can see from the chart below, unemployment has tended to reach close to full employment (circa 4-5% unemployment) only to be followed shortly afterwards by an economic recession (depicted by the grey columns in Chart 10 below). Unsurprisingly, these recessions also coincide with major bear markets involving index falls of 20-60%. The typical scenario is the strength of the economy causes either inflation to break out (which causes the Federal Reserve to accelerate its interest rate hikes) or the Fed raises rates too fast, too soon, which causes the economy to slow dramatically. Often, the preceding bull market has coincided with a period of rising debt levels, which exacerbates the impact of rising interest rates. Interestingly, it is the Fed acting too late that tends to cause the most severe economic downturns, as inflation initially breaks out (and needs to be contained) which requires a more aggressive and abrupt monetary contraction.

Chart 9:: Wage inflation is picking up; both average hourly earnings and employment cost index are rising

Source: BLS, DB Global Research

Chart 10:: The unemployment rate is low



Source: UBS, BLS

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Global macro – Risk of recession rising

Inverted yield curve is a worrying economic signal

An inverted yield curve remains a powerful signal of a potential looming recession. An inverted yield curve (where the return to investors on shorter-dated bonds is higher than that of longer-term bonds), has predicted all nine US recessions since 1955, with a lag of six to 24 months.

In 2013, the spread between short-dated and long-dated bonds was more than 2.5%. Today that gap has collapsed to less than 0.5%. The concern is that the long end of the curve is remaining relatively stable, despite ongoing increases in the short end, which could lead to an inversion which historically has been an extremely strong predictor of recession. Equally, in the event the long end increases significantly, that could be enough to slow the housing market, which could lead to a fall in house prices and consumer confidence.

One feature of the recent economic news that has not been widely reported has been the slowing of global economic data. The prevailing belief in "synchronised global growth", along with a very strong U.S reporting season is at odds with Citi's global economic surprise index which has rolled over in the last few months. This data set has historically been a good forward indicator of predicting inflection points in economic activity. We are not jumping to conclusions from one data set alone, but we remain wary of the risks from both rising inflation and a potentially weaker economic backdrop going forward.

Chart 11: US 10yr-2yr Government Bond Yield

Source: Bloomberg, Wall Street Journal

Chart 10:: Economic data has begun to undershoot expectations

Source: Bloomberg, Citi

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L1 Capital Overview

L1 Capital is a global investment manager with offices in Melbourne, New York and London. The business was established in 2007 is 100% owned by its senior staff, led by founders Raphael Lamm & Mark Landau. The team is committed to offering clients best of breed investment products. L1 Capital manages money for a range of clients including large superannuation funds, insurance companies, financial planning groups, family offices, high net worth individuals and retail investors.

L1 Capital uses a fundamental, bottom-up research process to identify investments with the potential to provide attractive risk-adjusted returns. The L1 Capital investment approach is largely style-neutral with modest value and contrarian characteristics. The firm launched its flagship L1 Capital Australian Equities Fund in August 2007. Since inception, the L1 Capital Australian Equities Fund has been one of the best performing large cap, long only funds in Australia, outperforming the S&P / ASX200 Accumulation Index by 4.9% p.a. (after fees).

Fund Information

Name	L1 Capital Long Short Fund
Class of Units	Daily
Structure	Unit Trust
Domicile / Currency	Australia / AUD
Inception	1 September 2014
Management Fee	1.54%
Performance Fee	20.50%
High Watermark	Yes
APIR / ISIN	ETL0490AU / AU60ETL04909
Minimum Investment	A$25,000
Subscription Frequency	Daily
Redemption Frequency	Daily

Service Providers

Responsible Entity	Equity Trustees Limited
Prime Broker	Morgan Stanley, Credit Suisse (Europe)
Fund Administrator	Link Fund Solutions
Fund Auditor	EY
Fund Custodian	HSBC
Legal Advisor	Hall & Wilcox

There have been no changes to key service providers since the last quarterly newsletter.

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Information contained in this publication

*All performance numbers are quoted after fees. All performance in this update prior to 3 October 2016 (being the date that the first retail class units were issued) relate to the monthly class units which are subject to a different fee structure. Beta, sharpe ratio, sortino ratio, maximum monthly drawdown, annualised standard deviation and annualised downside deviation relate to the monthly class units. 1. The value of the Fund's assets less the liabilities of the Fund net of fees, costs and taxes. 2. The redemption price is calculated by decreasing the NAV price by the sell spread (currently 0.25%). The NAV price is the NAV divided by the units on issue. Past performance is not predictive of future returns. Beta is calculated versus the ASX200AI. Maximum monthly drawdown is based upon calendar month net returns.

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