

# Firetrail Australian High Conviction Fund

APRIL 2019

## ABOUT FIRETRAIL

Firetrail is an investment management boutique which is majority owned by the Firetrail investment team. Additionally, the investment team is invested alongside clients in the investment strategies.

## AUSTRALIAN HIGH CONVICTION FUND

The Australian High Conviction Fund ("Fund") is a concentrated portfolio (approx. 25 companies) of our most compelling equity ideas. The strategy is built on fundamental, deep dive research guided by the philosophy that 'every company has a price'.

## INVESTMENT OBJECTIVE

The Fund aims to outperform the ASX200 accumulation index over the medium to long term.

## STRATEGY PERFORMANCE TO 30 April 2019

	Net Strategy	Benchmark	Net Excess
1 Month (%)	3.15	2.37	0.79
3 Months (%)	8.63	9.29	(0.66)
1 Year (%)	0.96	10.41	(9.44)
3 Years (%)	13.22	13.19	0.02
5 Years (%)	13.33	8.90	4.44
10 Years (%)	13.82	10.88	2.94
Inception (% p.a.)	9.99	7.02	2.97

### Past performance is not an indicator of future performance.

The Firetrail Australian High Conviction Strategy Composite Performance has been calculated using the monthly returns (after fees) of the Firetrail Australian High Conviction Fund from 14 March 2018 to current date, as well as the monthly returns of the Macquarie High Conviction Fund between 29 November 2005 to 23 November 2017. The Firetrail Australian High Conviction Fund employs the same strategy as was used by the same investment team that managed the Macquarie High Conviction Fund as at 23 November 2017. Firetrail has records that document and support the performance achieved as the Macquarie High Conviction Fund. All of the investment decision makers are employed by Firetrail Investments and the decision process remains intact and independent within Firetrail Investments. The Composite returns for the Strategy and the S&P/ASX 200 Accumulation Index (Benchmark) excludes returns between 24 November 2017 and 13 March 2018. During this period the investment team did not manage the strategy. As such, the annualised performance periods stated are inclusive of the combined composite monthly returns, and do not include the period when the team were not managing the strategy. For example, the annualised return over 3 years for the strategy and benchmark are inclusive of 36 monthly performance periods available in the Composite return period, excluding the period between 23 November 2017 and 13 March 2018. For additional information regarding the performance please contact us through the link on our website. Net Fund returns are in AUD terms. Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. Past performance is for illustrative purposes only and is not indicative of future performance.

## FUND DETAILS

Unit prices	30 April 2019
Application price	\$1.0223
Redemption price	\$1.0172
NAV price	\$1.0198

Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Number of Holdings	22
Fund size	\$370m
Management fee*	0.95% p.a.
Performance fee*	15% of outperformance

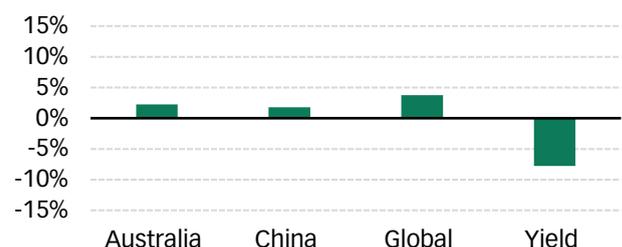
\*Please read the Product Disclosure Statement for more details

## PORTFOLIO POSITIONING 30 APRIL 2019

Top 3 Overweight Holdings (Alphabetical)
Amcor Ltd
Woolworths Group Ltd
WorleyParsons Ltd

## THEMATIC POSITIONING 30 APRIL 2019

Relative to the Benchmark



## PORTFOLIO COMMENTARY

The Fund returned 3.15% for the month end 30 April 2019, outperforming the ASX 200 Accumulation Index by 0.79%.

The market continued its recent strong performance. Calendar year to date the market is up 13.51%.

Key contributors to the portfolio's performance included holdings Reliance Worldwide, A2Milk and Commonwealth Bank. Key detractors from performance included positions in Rio Tinto, Atlas Arteria and Qantas.

In this month's portfolio commentary, we share insights on:

1. How the portfolio is positioned?
2. Why we believe we are likely at peak cycle margins?
3. Takeover activity in 2019...

### HOW THE PORTFOLIO IS POSITIONED?

Every stock we own has its own story. Some are market share winners. Others are unloved gems. The common thread between each of them is that we believe they are all outstanding investments.

In our view, 'every company has a price.' We aim to find and invest in companies that we believe are undervalued over the medium-term, with no material disappointment in the short-term.

Today, the portfolio is positioned in several companies that we believe can grow earnings, without being overly reliant on strong economic growth. The focus on bottom up stock selection has led to a mix of opportunities including:

- **Market share winners** - including Woolworths, Cleanaway Waste Management, Reliance Worldwide and A2Milk
- **Non-GDP linked Cyclical** – including Worley, Nufarm and Orica
- **Acquisition led earners** – including Amcor and Clydesdale

In the current macroeconomic environment, we believe these diverse stock specific opportunities are well placed to deliver outperformance for our investors over the medium to long-term.

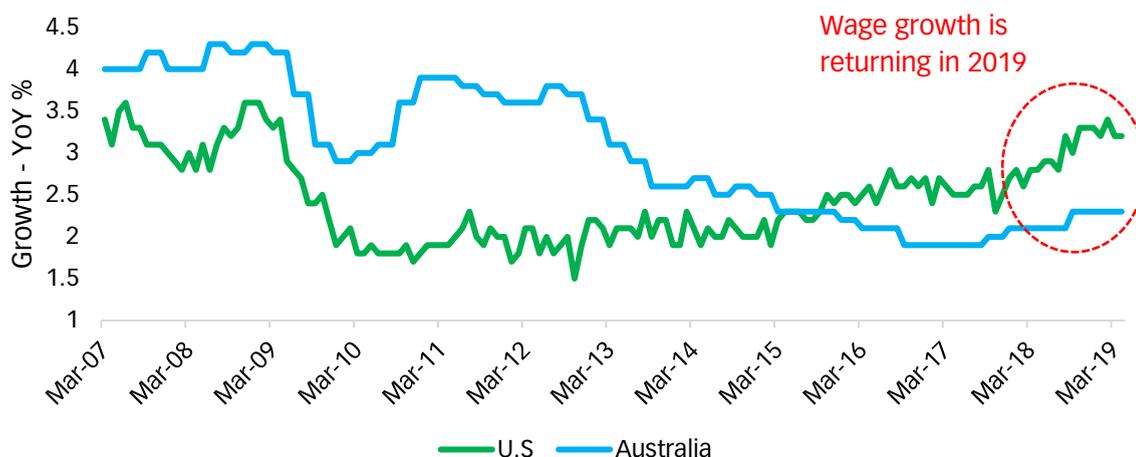
### WHY WE BELIEVE WE ARE LIKELY AT PEAK CYCLE MARGINS?

Our investment team travels extensively to gain insights on what is happening on the ground across industries and geographies. Recent trips across Australia, Asia, US and Europe had one thing in common... Consistent feedback that operating margins are under pressure. Our conclusion is that margins have likely peaked for this cycle, driven by labour inflation. And it's a pretty common part of economic cycles. Over time you see margins peak before the cycle does.

Any company with a large workforce, low margins and poor industry structure (i.e. many competitors) is at risk. Low EBIT margins make a business more vulnerable to labour inflation, because small changes in costs can have outsized impacts on profit. Having compared notes across the investment team, Australia and US are the places with the most acute labour inflation concerns. Recent commentary from many Australian retailers indicate that labour force headwinds are building this year and next year. As the chart below indicates, after a decade of low wage growth, wage growth is returning.

#### Chart 1. Wage growth is returning across US & Australia

Hourly wage growth - YoY %



Source: Bloomberg

One company we own, which looks vulnerable on the surface is supermarket operator Woolworths. They have a large wage component in their cost base and make less than \$5 for every \$100 of sales to shoppers. Rising labour costs, most notably, through contractual Enterprise Bargaining Agreements (EBAs) will be a meaningful headwind over the next 18 months. We believe the mitigating factor for Woolworths is the fact that they have been investing aggressively in-store over the past few years. As a result, Woolworths have more levers to reduce costs compared to their competitors, and they will need to pull them to generate earnings growth over the next few years.

## TAKEOVER ACTIVITY IN 2019...

The Australian stock exchange has seen a fair bit of takeover activity already this year. The hunters have been a mix of public companies, private equity firms and industry super funds. Some of the approaches have succeeded, others have failed, and many others are a work in progress.

### 2019 M&A has included:

- Australian paint company Dulux receives bid from Japanese paint company, Nippon Paints
- Casino resort operator Crown receives an approach from global casino giant, Wynn
- Car auto sales business AP Eagers bid for fellow dealer, Automotive Holdings
- Government owned investment company QIC bids for network connectivity player Superloop
- Fintech specialist Bravura bids for fellow fintech GBST
- Wesfarmers bids for resource companies Kidman Resources and Lynas Corp

The deals so far in 2019 build on last year's 56 deals, including high profile deals such as Healthscope, Graincorp and MYOB.

With such a diversity of acquisitions, there is no one common thread. But there appears to be a few common features that are attractive to acquirers:

- 1) **Diversified customer bases** – lowering the risk of the acquisition
- 2) **Asset backing** – a clear valuation backed by land, long term licences or long-term recurring contracts
- 3) **Stable earnings and low gearing** – offering the acquirer higher gearing potential, and lower equity contribution
- 4) **Management not executing** – new owners could see an opportunity to run the business better

Buying a potential takeover candidate is exciting because of the quick 30% return on offer. However, many times we are faced with opportunities to invest in amazing publicly listed assets that we don't believe are being run efficiently. In our experience, these are precisely the type of companies that are eventually taken over. However, as longer-term investors we generally steer clear of these kinds of companies because takeovers are rare.

## ONE INTERESTING THING THAT HAPPENED THIS MONTH...

North America's largest e-sports event was hosted in April 2019 in St Louis, Missouri. The final for computer game, **League of Legends** had 600k live streamers, that is, people who wanted to watch other play video games. For many people in the world older than 30, getting their head around people watching people plays games is hard to fathom. However, in physical sports, people have been watching others since the Romans. So, it's not really that big a stretch, although it is certainly different.

What was amazing to learn, was the 2018 world championships of League of Legends were watched by close to 100m people, eclipsing the Super Bowl! Just a couple of years ago, I would have said that owners of sporting codes such as NFL, EPL and the AFL were the big winners out of technology. The thesis was that their product was in demand from consumers. And in a quest for viewership, 'old world' Free to air TV and Pay TV would compete with 'new world' internet streaming giants to increase the value rights every year. But things change. E-sports is on the rise. I wonder if the board rooms of some of the biggest sporting codes are discussing the competitive threats from e-sports? If so, the lesson around the world repeatedly is to disrupt yourself. The earlier you take the pain, the less pain you will have to take and less it will cost.

---

Firetrail Investments Pty Limited (ABN 98 622 377 913) ('Firetrail') is an Authorised Representative No. (1261372) of Pinnacle Investment Management Limited (ABN 66 109 659 109 AFSL 322140). Interests in the Firetrail Australian High Conviction Fund ARSN 624 136 045 (the 'Fund') are issued by Pinnacle Fund Services Limited (ABN 29 082 494 362 AFSL 238371), the Responsible Entity. The Responsible Entity is not licensed to provide financial product advice. You should consider the Product Disclosure Statement ('PDS') in its entirety before making an investment decision. The current PDS of the Fund can be found at <https://firetrail.com/products/firetrail-australian-high-conviction-fund>. Firetrail is the investment manager of the Fund. Firetrail and Pinnacle Fund Services Limited believe the information contained in this communication is reliable, however its accuracy, reliability or completeness is not guaranteed. To the extent permitted by law, Firetrail and Pinnacle Fund Services Limited disclaim all liability to any person relying on the information in respect of any loss or damage however caused, which may be suffered or arise directly or indirectly in respect of such information contained in this communication. Any opinions or forecasts reflect the judgment and assumptions of Firetrail and its representatives based on information at the date of publication and may later change without notice. The information is not intended as a securities recommendation or statement of opinion intended to influence a person or persons in making a decision in relation to investment. This communication is for general information only. It has been prepared without taking account of any person's objectives, financial situation or needs. Any persons relying on this information should obtain professional advice before doing so. Past performance is not a reliable indicator of future performance.

## MORE INFORMATION

General enquiries 1300 010 311  
Existing client enquiries 1300 360 306  
[www.firetrail.com](http://www.firetrail.com)

**Firetrail**  
INVESTMENTS