AORIS INVESTMENT MANAGEMENT

2019 Letter to Investors

January 2020

Dear fellow investor,

I am pleased to share with you my thoughts on the year just passed; our first full calendar year managing funds as an independent business.

In annual reports I read, the best letters from CEOs to their shareholders have three important characteristics. Firstly, they are personal, meaning they have clearly been written by the CEO, not by the PR department. Secondly, they provide a fair and balanced assessment of the year under review, including the things that didn't go well. Thirdly, they tie the performance of the business and decisions that were made during the year directly to the company's purpose, or its raison d'être. This is the spirit in which I write this letter to you.

Our purpose is to be the best custodian of capital available to our clients. To fulfil our purpose, our objective is to generate investment returns of 8–12% p.a. after fees over a market cycle; let's call it seven years. Our approach to accomplishing this objective is threefold:

1) invest in businesses that we believe will become more valuable over time;
2) at prices equal to or less than our appraisal of the company's fair or 'intrinsic' value; and
3) where the risk of disappointment is low.

We expect the bulk of our investment returns will be derived from the increase in value of the companies we own and the dividends paid out to us along the way. We expect a smaller contribution will come from the benefit of having purchased these investments for less than their intrinsic worth.

Against the positive wealth-creation impact on investment returns of businesses that meet or exceed our expectations, must be balanced the drag on performance of those that don't. From goals scored must be deducted goals conceded. We seek to minimise the frequency *and* the severity of investment errors.

To maximise the likelihood that the businesses we choose to own do indeed become more valuable over time, and to minimise the risk that they fall materially short of our expectations, we are willing to construct portfolios that look very different from most other investment managers. We are comfortable avoiding large sections of the equity market such as financials, resource companies and highly regulated businesses. We believe we will make our best investment decisions if we make relatively few of them, so we limit our portfolio to 15 holdings. We also believe we will make our best investment decisions if we keep both our *investment process* and our *business* as simple as possible. We will eschew the commercial opportunities of creating additional investment products, and instead focus on doing our one thing and doing it well. In this, we are very unconventional.

HOW DID WE DO IN 2019?

On one level the answer to this question is clear and simple. For our Class A (unhedged) fund, our investment performance after fees in 2019 was 36.5%, which compares very favourably to the return of our benchmark (the MSCI AC World Accumulation Index ex-Australia) of 26.9%, and to the vast majority of our international equity manager peers. Our 2019 performance was also well above our long-term objective of 8–12% p.a.

	Aoris	Benchmark
2019	36.5%	26.9%
2018 – nine months to Dec	3.2%	0.1%
Annualised since inception*	21.6%	14.6%

*28 March 2018

Portfolio performance tells only part of the story. The variables that I place the greatest weight on and believe are most meaningful for clients in evaluating us are:

- our *success rate*, or the percentage of stocks we have owned that have outperformed the market while we have owned them; and
- our success in avoiding the *worst 20%* of the market.

Our success rate

We owned 19 stocks during 2019, 10 of which were held for the whole calendar year and nine that were bought or sold during the year. Of these 19 investments, 12 – or 63% – outperformed our benchmark during the period we owned them. This is a pleasing outcome, as only 43% of the stocks in a universe of around 4000 international companies that have a market capitalisation of above $4 billion, or what we broadly consider our investible universe, outperformed our benchmark in 2019.

Of the seven investments that underperformed the market during the period we owned them, the worst of them was Croda, which was roughly flat during the seven months we owned it, compared to an 18% appreciation of our benchmark over the same period, detracting about 1% from our portfolio return for the year.

Avoiding the bottom 20%

Our single most important objective each year is to minimise our participation in the worst performing quintile of the market. On this we were successful in 2019. No stock we owned was in the bottom 20% of the market during the period we owned it.

Stocks in the bottom 20% of the international equity market declined on average by approximately 11% in 2019, underperforming the market aggregate by a whopping 38%. This group included some very large and well-known companies, such as Pfizer, FedEx, Telefonica, China Mobile, and KraftHeinz, among many others.

By avoiding the worst 20% of the market, the positive impact on our investment returns and client financial capital is readily apparent, mathematically adding around 8% to performance for the year. Less obvious but also significant is the benefit to the 'psychological capital' of the investment manager. When an investment team is dealing with a stock that has suffered severe losses, the detrimental impact on decision-making efficacy, research productivity and team morale can be pronounced. A great deal of time and energy may be spent analysing a negative event, with inherently unquantifiable long-term implications such as legal risks, adverse changes in regulation, product failures, contract losses, increasing competition, a restructuring program gone awry, poor management, or major commodity price movements. The investment team can struggle to regain the confidence necessary to make good judgements in the future. Much like a professional athlete returning to competition after a serious injury, their body may be healthy, but confidence and decisiveness can suffer lasting damage.

Once again, our primary objective for 2020 will be to complete the year with no participation in the bottom 20% of the equity market.

PROCESS IMPROVEMENT

In late 2018, we elevated our criteria for assessing business quality in several important ways. These process iterations were discussed in our December 2018 Quarterly Report and they made a meaningful and positive contribution to our investment returns in 2019.

- We placed increased emphasis on what is termed 'organic' growth, which means the rate at which a company increases revenue after removing the impact of acquisitions and currency changes. We want to own businesses where organic growth over a long period has been at least in line with nominal GDP, say 3–4%.
- We increased our emphasis on businesses that prioritise organic growth over margin expansion. Expanding profit margins can drive earnings growth for a while, but is ultimately limited and may encourage companies to withhold making investments that improve the long-term growth and health of a business.
- We have also increased our preference for businesses where the product or service improves and becomes more valuable to their customers with each passing year. This supports pricing power and a high retention of happy customers.

Great businesses don't just earn high profit margins with stable revenue. Great businesses don't tread water. Great businesses don't increase earnings just through expanding profit margins or making acquisitions. Great businesses grow. They grow revenue through winning more customers, selling more things to existing customers, and adding value in ways that support higher prices.

As a result of this quality recalibration, we removed several companies from our portfolio and from our watch list. To maximise our success rate in owning businesses that do become more valuable over time, we seek to eliminate from our opportunity set those businesses at risk of stasis and competitive regression.

WHAT WE DIDN'T GET RIGHT AND WHAT WE LEARNED

We owned three businesses in 2019 that we shouldn't have.

In the case of both Croda and Idex Corporation, organic growth has been sub-par, not only in the last year or so but also over their longer histories. For both companies, our assumption when making the investment was that changes in product mix and improved operational management would produce a more attractive underlying growth rate in the future. We have a general rule that we don't expect the future of any business we own to be better than its past, and our error with Croda and Idex was in making an exception to this rule.

RELX Plc is a professional information and data company and its largest activity is peer-reviewed academic journals. In its academic publishing business called Elsevier, RELX is a company with a complex set of buyer–seller relationships, with interests and incentives that are somewhat at odds. Many universities and external funding bodies increasingly want research that they fund to be published 'for free, for everyone, forever'. This 'open access' model is incompatible with Elsevier's subscription model. We have a strong preference for businesses with simple, one-to-one buyer–seller relationships. Our error in the case of RELX was not appreciating the complexity of the academic publishing model, and being slow to recognise the discontent within its customer base.

THE 2019 YEAR FOR AORIS AS A BUSINESS

For Aoris as well as for our clients, 2019 was a very pleasing year. We increased the value of funds we manage from $89 m to $244 m, and we enter 2020 as a profitable enterprise. Our Fund has been added to the investment menus of a number of leading administrative 'platforms', including Macquarie Wrap, BT Wrap/Panorama, HUB24 and Netwealth, making us available to more financial advisory practices. In November, our Fund was awarded an Approved rating from Zenith, an important recognition of its investment merits.

We spent several sessions early in 2019 discussing the *values* we believe in and want to represent as individuals, as a team of people and as a business. We distilled these down to six, which we added to our Owner's Manual and to our website. The words themselves, such as Clients First, Collaboration and Humility may sound superficial or even generic to some people. It will be the choices we make, what we choose to do and what we choose not to do that determine the degree to which these values hold their authenticity. We certainly strive to be an organisation with a culture of *meaning* and *purpose*.

Late in the year we engaged in our first annual community service day, cooking food for the Salvation Army's Oasis Youth Support Network. Each of us at Aoris felt energised by it and grateful for the opportunity to make a small but positive contribution to those less fortunate, through our work time.

As a business, we recognise that we operate in an exceptionally competitive market. People and organisations have a great many choices when it comes to investment managers. We not only have to deliver excellent results to our clients over time, but we also have to work hard to get better. I often illustrate this by contrasting the discipline of investment management with the scientific disciplines. In science, knowledge and understanding is *cumulative*. Through the ages, scientists have made major discoveries about how the world works – DNA, atomic structure, gravity, electricity, etc. Through the application of the scientific method, these start as theories and are eventually accepted as truth and provide foundations on which future knowledge is built. By contrast, in finance, knowledge is *cyclical*. In aggregate, the finance industry gets no cleverer; it makes the same mistakes cycle, after cycle, after cycle. At Aoris, we try to be more like scientists – we work hard to improve our investment process a little each year and make those improvements *cumulative*.

THE YEAR AHEAD

This time of year is full of prognostications about the future and no doubt you will be reading from others what they believe 2020 has in store, both for major economies and financial markets (social and political events too, perhaps). The more unequivocal the forecast, the more believable it is, and the smarter, more sophisticated the commentator espousing the view sounds. It has taken me a long time to reach a point of feeling truly comfortable saying 'I don't know'. The more I have observed financial markets and economic activity over many years and cycles, and the more I have created feedback loops between what I thought would happen and what did happen, the more I realise that I know less than I thought I did. What I have also grown to understand is the things we think we can, or wish we could, anticipate don't matter nearly as much as some may think. Whether central banks increase or decrease interest rates in 2020 won't change what most businesses are worth.

We begin 2020, as we begin every year, with a long list of risks to worry about. Some managers will increase cash, or perhaps 'short' equities just as they feel these risks are about to materialise. At Aoris we are confident that we can't *predict*, but we also believe we can *protect*. We don't only fasten our seatbelts when we think a reckless driver may be ahead; we wear seatbelts every time we get in the car. We manage risk and seek to protect capital through the types of businesses we avoid *all* the time. We own only *all-weather* businesses that have proven to remain highly profitable during periods of economic stress, including through the GFC, *and* have proven competitively resilient, *and* are financed with conservative capital structures, *and* are run by conservative-minded management.

We also begin 2020, as we begin every year, feeling both cautious and confident. We are cautious, as we know around two-thirds of listed companies underperform the broad market each year and a large percentage of them decline in value. We are confident that through the disciplined application of our investment process, and through owning businesses that we believe will become more valuable over time where the risk of disappointment is low, we will achieve after-fee investment returns of 8–12% p.a. for our clients over a market cycle.

Wishing you the best for 2020.

Sincerely,

Stephen

Stephen Arnold
Chief Investment Officer

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A COMMONSENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE

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