AORIS INVESTMENT MANAGEMENT

2020 Letter to Investors

January 2021

Dear fellow investor,

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 to us along the way. We expect a smaller but still meaningful 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 from 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 businesses in highly regulated industries. 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 highly unconventional.

HOW DID WE DO IN 2020?

For our Class A (unhedged) fund, the investment performance after fees for 2020 was 0.4%, which compares to a return of 6.0% for our benchmark (the MSCI AC World Accumulation Index ex-Australia). For our Class C (hedged) Fund, the investment performance after fees for 2020 was 6.6%, which compares to a return of 11.2% for its benchmark the MSCI AC World Accumulation Index ex- Australia (hedged). This was a disappointing result from our perspective in terms of our absolute return and our underperformance relative to our benchmark. In the paragraphs that follow I have provided some attribution to help readers understand the performance shortfall, as well as why I feel very confident going into 2021 with the quality of the businesses we own and our overall portfolio positioning.

	Aoris[1]	Benchmark	Difference
2020	0.4%	6.0%	-5.6%
2019	36.5%	26.9%	9.6%
2018 – nine months to Dec	3.2%	0.1%	3.1%
Since inception - annualised	**13.5%**	**11.4%**	**2.0%**

[1] Class A, inception 28 March 2018

While 2020 is the subject of this letter, our focus is always on the longer-term outcomes, meaning our since-inception returns. The significance of our performance record when measured from the Fund's inception grows with each passing year – in statistical parlance, the signal-to-noise ratio rises with time. The ingredients we believe are key to us achieving our long-term investment objectives 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 18 stocks during 2020, of which 11 were held for the whole calendar year and seven were bought or sold during the year. Of these 18 investments, 10 – or 56% – outperformed our benchmark during the period they were owned in 2020, including 8 of the 11 stocks held for the full year. This is a pleasing outcome, as only 34% of the approximately 5000 international companies that we consider our investible universe outperformed the average in 2020.

Since the inception of our Fund we have owned 27 stocks, 63% of which have outperformed our benchmark over the full period we have owned them, which is a statistically excellent outcome.

Avoiding the bottom 20%

Our single most important objective each year is to minimise our participation in the worst performing quintile of the market. In 2020 Compass Group, which we sold 11 weeks into the year, narrowly made it into the bottom quintile when measured over that brief period of time.

Since the Fund's inception, none of the 27 stocks we have owned were in the bottom 20% over the full period we owned them, which is a very pleasing outcome.

Looking at our 5.6% performance shortfall relative to our benchmark, the benefits of our high success rate of outperformers and from largely avoiding the bottom 20% was more than offset by not owning the IT and e-commerce super-performers. In fact, our lack of participation in this group of winners represented a performance drag in the order of 6-8% versus our benchmark. Looking at the stocks we did own, the positive impact on returns of our major outperformers, such as MSCI Inc., Nike and Graco, was more than offset by the impact of our underperformers, which were Compass Group, ADP, CDW and Costco.

Those are the numbers, the objective truth. Let me now provide some context to those numbers. The year 2020 was the most challenging I have experienced during my three decades in investment markets. The sharpness and severity of share price moves was, at times, disorientating. In parallel to severe stress in financial markets, everyone everywhere was dealing with profound changes in their personal lives and concerned for both their health and their livelihood. Anxiety levels ran high for much of the year.

It felt like a year that rewarded investors for belief and boldness. Let's look at some of the big winners. Tesla, yet to make an annual profit from selling electric vehicles (as distinct from selling emission credits) rose by more than 7x and, as at the end of the year, was valued at over $875 billion, making Elon Musk the world's second-richest individual (as of early-January, Musk has since gone one better). Large US technology and e-commerce companies such as Amazon, Apple, Facebook, Alphabet (Google), Microsoft and Salesforce.com saw gains of 30–60%, as working from home accelerated many changes these businesses were already benefiting from. The Chinese equivalents such as Baidu, NetEase and JD.com posted gains of 40% or more. A group of smaller, fast-growing enterprise software, payments and cloud computing companies contained many outsized winners, such as DocuSign (up 175%), Square (up 220%) and Cloudflare (up 310%). Lastly, work-from-home beneficiaries included Zoom (up 3.5x and now with a market value of more than $120 billion) and Peloton (whose market value rose from about $10 billion to $60 billion). The experience in our domestic equity market was similar, with extraordinary gains from the likes of Afterpay, Kogan and Xero. The year 2020 was all about growth and disruption. You just had to believe.

The sharp share price rises of the large technology stocks, a group often referred to as the FAANGs (Facebook, Amazon, Apple, Netflix and Google – now known as Alphabet), has made the feature article that I wrote in our September 2019 Quarterly Report to clients titled 'FAANGs – The sun has set on their days of dominance' look premature, at best, in its thesis. In 2020 the sun, in fact, still shone brightly on big tech. Perhaps I would have been better off writing 'The triumph of technology' and investing accordingly! Our lack of ownership of disruptive growth stories could be interpreted as having our heads buried in the sand regarding the rising importance of technology in all facets of corporate and consumer life. We are not, in fact, luddites, but we are naturally conservative. There are four primary reasons for our caution insofar as disruption is concerned.

Firstly, developing, fast-growing markets are often naturally unstable, with fluid movements in market share. Electric vehicles and the techy parts of the payments industry are two good examples where revenue growth for the current participants is fabulous, but new competitors are emerging all the time and the long-term winners are yet to be sorted out from the rest. Further, regulation may well play a significant role in these two industries in time, but today is an important unknown. We prefer markets that are more mature, where we can identify the long-term winners with confidence.

Secondly, new and disruptive companies are typically, by their nature, narrow. They have created their business around doing one thing, which makes them inherently fragile. If their one thing gets overtaken by competition or regulation, they have nothing to fall back on. Tesla, Zoom, Beyond Meat, and Square are just a few examples of this. We prefer businesses that are not only dominant in more established markets, but also have a degree of breadth across multiple markets.

Thirdly, breakthrough innovations sometimes simply don't actually break through and become the large, profitable market that had been expected. Five years ago General Motors, Amazon, Softbank, Google and others were spending billions of dollars to acquire or develop autonomous vehicle (AV) businesses, amid promises of a rapid revolution. Tesla said it would have as many as a million autonomous 'robo taxis' on the road by the end of 2020. Self-driving cars remain all promise and no production, and it was interesting to see Uber divest (in reality, pay to have it taken off their hands) their AV operation in December.

Lastly, price matters. A third of our portfolio candidates (our bench) are outstanding IT companies with long-established dominant positions in markets that are very resistant to new entrant competition. The reason they are not in our portfolio is that they are priced at levels significantly above what we believe constitutes fair value. That was true at the start of 2020 and is even more so today.

We owned four IT-related businesses during the year, but their performance was more representative of the overall equity market than of the IT sector. Accenture (IT outsourcing and consulting) rose 15% while Amphenol (IT connectors and sensors) rose 11%. Jack Henry, a leader in core account processing software for small US banks and credit unions, performed satisfactorily, with a return of 2%. CDW, which is the largest reseller of IT hardware and software to small and medium-sized US corporates, was our best performing stock in 2019 but in 2020 its share price declined by 15%. Its revenue last year was negatively impacted by cutbacks in corporate IT budgets as well as the move to work-from-home. Through 2020, CDW continued its long history of gaining market share, and as the US economy recovers we expect its earnings will follow.

Our process is to look for established winners in growing but competitively stable markets where we don't have to make leaps of faith into the future. For instance, we own L'Oréal and have a high degree of confidence that its leadership position will only strengthen over the next five years and beyond. I have found this conservative approach to be enormously beneficial over time in helping avoid the mistakes that we would inevitably make in seeking out the big winners from the next exciting growth market.

Of course, 2020 was not just about tech and disruption, belief and boldness. It was dominated by COVID-19, which early in the year rapidly became a global health and economic crisis, and immediately spilled over into financial markets. Over a four-week period to mid-March, equity markets fell by around 25%. While disappointed that our performance trailed that of our benchmark, I believe that our process and discipline helped us in four important ways in navigating the challenges that 2020 presented.

Firstly, we keep our investing as simple as possible. We manage a single fund and we own a maximum of 15 stocks. In 2020, this allowed us to put a lot of consideration into each business in the portfolio as we assessed their resilience to the changing external conditions.

Secondly, we avoid banks, energy companies and highly indebted businesses, which kept us out of many of the real problem areas brought about by the pandemic.

Thirdly, we entered 2020 with a portfolio of companies well positioned for the challenges that lay ahead (Compass, described below, being the notable exception). This year was not only an *accelerator* for digital transformation, but was also a *separator*, amplifying the differences between the best businesses and the rest. For example, Nike, L'Oréal and Accenture each lead their respective markets and through 2020 they were able to pull away from their peers at a faster-than-normal rate, emerging competitively stronger and more valuable than they started the year. Their conservative balance sheets meant that they could continue to invest in their brand and talent pool while some competitors had to cut back on these essential investments.

Lastly, we don't take portfolio cash levels up or down to express views on the equity market because we simply don't have such views. Staying fully invested served us well as the equity market recovered strongly from April onwards.

WHAT WE DIDN'T GET RIGHT AND WHAT WE LEARNED

Compass Group, which we sold in March, was our primary error of commission in 2020. Compass's business proved to be highly resilient through the 2009 economic crisis, but not so in 2020. As a contract caterer, Compass sells meals at sporting events, university campuses, hospitals, and places of work. As work-from-home directives were issued and sporting events were cancelled in the northern hemisphere during February and March, we were slow to join the dots and to appreciate the duration and severity of the impact this would have on Compass's profitability. Over the period from 1 January to the point we sold it in mid-March, Compass's share price fell sharply and this had a material impact on portfolio performance.

What we learned from this experience is the limited value of history as a guide to how a particular business will be impacted by an external crisis, because each crisis is different. We needed to apply more expansive thinking to appreciate what was different about COVID-19 and be more agile in our response to rapidly changing conditions.

THE 2020 YEAR FOR AORIS AS A BUSINESS

This was a year of growth and progress for Aoris. The value of funds we manage for clients increased from $244 million to $342 million. In June we welcomed two new analysts, taking our investment team to five. Delian Entchev is Bulgarian by birth and spent seven years covering domestic and international equities before joining Aoris. Vic Guha was born in India and brings a background in science (anatomy and histology) as well as business, and joined Aoris as a graduate. Our team will benefit from the diverse backgrounds and perspectives each brings. In November, the Aoris International Fund was upgraded by Zenith to a Recommended rating, an important recognition of its investment merits and a vote of confidence in our business.

We were disappointed not to be able to hold a community service day in 2020 – something that we intend to be an annual event – due to COVID-19 restrictions. Understandably, places where we would like to contribute a day of our time, such as hospitals and homeless centres, declined on-site volunteers through most of the year. As an alternative, we raised money for the Fight Cancer Foundation in support of kids with brain cancer by joining in their favourite footy colours day. We are hopeful that COVID-19 restrictions are lifted in 2021 and we can spend a day in the community helping those in need and building a culture of humility and service at Aoris.

THE YEAR AHEAD

Naturally, you will be reading many forecasts, divinations and prognostications from journalists, market commentators and investment managers as to what 2021 will bring in terms of financial markets, key political events and major policy moves. I gave up soothsaying long ago, because so few of my economic predictions came to pass. I would have told you a decade ago that the post-GFC economic recovery would see inflation above 2%, that US 10-year bonds would return to historic norms of 4–6% (they have been below 3% for most of the last five years), that the Chinese property market was an impending disaster and that the Australian dollar should spend an extended period of time below 70 US cents. What I have also grown to appreciate is how little this matters for most companies. We want to own businesses that we can be confident will grow in value over time, independent of external events and macroeconomic variables that we know we can't predict.

As I look at our portfolio today, the vast majority of businesses we own meaningfully improved their competitive position, earnings power and intrinsic value in 2020. For many of them, the crisis illuminated strengths that were always present but less visible in an 'ordinary year', which was reflected in both high levels of new customer wins and elevated levels of satisfaction from existing customers. They enter this year from a position of strength.

So, we begin 2021 as we begin every year, feeling both cautious and confident. We are cautious as we know that the economic aftershocks of the COVID-19 crisis will be with us for years and that the pace of change presents an ever-greater challenge for most businesses to evolve and stay relevant to their clients. To stand still is to regress. I am confident that through owning a concentrated portfolio of exceptional businesses, which we expect to become progressively more valuable over time and where the risk of disappointment is low, we will achieve after-fee returns of 8–12% p.a. over a market cycle.

I wish you and your loved ones the very best for 2021.

Sincerely,

Stephen

Stephen Arnold
Chief Investment Officer

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