

2021 Letter to Investors



January 2022

Dear fellow investor,

In annual reports I read, the best letters from CEOs to their shareholders have three important characteristics. First, they are personal, meaning they have clearly been written by the CEO, not by the PR department. Second, they provide a fair and balanced assessment of the year under review, including the things that didn't go well. Third, 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, our third annual 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 are business owners. 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. Our industry likes to categorise managers as either 'growth' or 'value', a view of investing that I consider binary and limiting. As you can see, our approach is to invest where we have growth and value working in tandem.

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 we must deduct goals conceded. We seek to minimise the frequency and the severity of investment errors.

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.

I am delighted to report to you that the investment performance after fees in 2021 for our Class A (Unhedged) fund (the Fund) was 41.3%, significantly exceeding the 26% return from our benchmark (the MSCI AC World Accumulation Index ex-Australia).

Class A (Unhedged)	Aoris ¹	Benchmark	Difference
2021	41.3%	26.0%	15.3%
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	20.3%	15.1%	5.2%

¹ Class A, inception 28 March 2018.

When evaluating our performance, as well as measuring us against our benchmark, it's also appropriate to compare our results to those of our peers. I am pleased to report that for 2021, the Fund ranked in the top 1% of a broad universe of international equity funds, as defined by Morningstar.

While 2021 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. Our performance since inception significantly exceeds both our 8-12% p.a. objective and that of our benchmark, and ranks us in the top 5% of peer funds.

Performing well in 2021 did not, in my view, require having unusual foresight as to the unfolding COVID-19 pandemic, the direction of inflation, or changes in central bank policy. It didn't require adroit market timing, betting on a 'growth-versus-value' trade, owning bitcoin, shorting China, or identifying the next disruption theme. It didn't even require being in the best performing sectors of the equity market.

The two things I believe helped us perform well in 2021 were:

1. **Seeking and appreciating 'mean aversion'.** Our process is to own established winners in growing but also competitively stable markets. We look for leading businesses that are taking share in markets where share does not move around easily, and we want to see this evidenced over many years.

There are many industries where being the biggest does not bestow particular benefits – banking and insurance come to mind. In some businesses, size (and the complexity that often accompanies it) becomes a deadweight, slowing the organisation down and contributing to a regressive, mean-reversion effect. There are numerous examples of this: 3M, IBM, GE, Sony and Honeywell being just a few.

In some industries, though, and where the management team understands the winning hand it possesses, the size and scale enjoyed by the leading participant confers huge advantages in the form of purchasing muscle, brand impact, investment in innovation, and the ability to attract talent. In these industries, as the largest player pulls further away from its peers each year, that size advantage becomes progressively more powerful. Strength through size is self-reinforcing; growth begets growth.

I believe that as a rule, businesses with leadership positions, drawing on the advantages that leadership brings and the characteristics that got them there in the first place, will navigate challenging conditions better than most of their peers. I wrote in last year's annual letter, *'This year (2020) 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.'*

The challenging external conditions experienced by most industries in 2021, which began with COVID-19 shutdowns and morphed into supply chain disruption, inflation and labour shortages, were again a separator between the best businesses and the rest. L'Oréal, for example, outgrew its industry by 4% in 2020, the largest differential in more than 30 years. In the first nine months of 2021, that growth differential widened to a remarkable 8%. Costco has been able to keep its shelves stocked, manage inflation and grow its workforce more effectively than most of its peers, and has increased sales last year in its home market, the US, at roughly double the rate of overall consumer spending.

2. **Staying the course.** Owning a portfolio of winning businesses where we understand the foundations of their competitive success, gives us confidence to stick with them through periods of market neglect or misplaced concerns. Three of our strongest contributors in 2021 – CDW, Accenture and Costco – were among our poorest performers the prior year. Their underperformance in 2020 was not a function of any fundamental deficiency or deterioration; rather, they seemed dull in a market environment enamoured of shiny new things, like loss-making food delivery businesses and electric vehicle start-ups. These three stocks were among our largest portfolio position sizes right through 2021 and we benefited handsomely from their recovery.

For many businesses in our portfolio, the challenging operating environment over both 2020 and 2021 illuminated strengths that were always present but less visible in an ordinary year. Just as you may be surprised and delighted by impressive personal characteristics of a family member that come to the fore in difficult times, I was frequently intrigued by the qualities of our companies that the stressed external conditions brought to the surface, which contributed to outsized market share gains.

A good example of this is Cintas, which is the leading provider of uniform rental services and restroom supplies to businesses in the United States. Cintas' corporate history began in the Great Depression, and the memory of those formative years and what was required to survive them has led to an organisational culture that is both long-term minded and highly customer centric. Over the last two years, Cintas has lengthened payment terms for customers getting back on their feet and hasn't been hasty in raising prices. As its clients reopened their premises during the second half of 2020, Cintas used its sophisticated global supply chain to procure essential sanitation products that its customers could not access themselves, generating not only revenue but also considerable goodwill in the process. Today, Cintas' customer satisfaction and customer retention rates are both at record levels.

The importance of durable growth

Growth is central to how we think about business quality. We look for businesses growing their revenue on an organic basis, meaning without help from acquisitions, at a minimum of 4% p.a. over an economic cycle. Being in a growing market is not enough; we want to own companies that are consistently outgrowing their markets through the addition of new customers and doing more business with their existing customers.

For many people, though, 4%+ top-line growth sounds a bit pedestrian. I certainly understand the allure of investing in disruptive, rapidly growing companies – countless books have been written on them and many fortunes made by those who invested in them. However, investors often get themselves into trouble by looking for the next one. Fast-growing companies are typically in fluid markets where the long-term winner is yet to be determined and regulatory parameters are perhaps still being debated. Growth attracts competition, and the conversion of promise to lasting profit is low.

At the same time, investors frequently underestimate the compounding power of winning businesses that grow a few percent faster than average at high profit margins and reinvest capital at attractive rates of return, repeated over many years. You may be surprised to learn that for the top 2000 companies globally, the median growth in earnings per share (EPS) over the ten years to 2020 was less than 1% p.a., according to FactSet. For the 15 companies held in our portfolio, EPS growth over that period averaged 13% p.a., ranging from a low of 4% p.a. to a high of 20% p.a.

Thoughts on risk and how best to measure it

Investors are naturally interested not just in their returns, but also in the risk that was taken to generate them. Risk speaks to repeatability of process, and it also speaks to the expected consequence of mistakes. But how best to capture investment risk? Investing is a very quantitative, measurable endeavour; however, as Albert Einstein said, not everything that can be counted, counts.

One frequently used measure I believe is prone to overinterpretation is volatility. Volatility calculates the variability in a manager's monthly returns, and when compared to that of a benchmark it is considered an industry-standard expression of portfolio risk. Volatility has some merit as a measure of risk because of human behaviour. Given an unduly bumpy ride, an investor will enjoy the sharp upswings in their portfolio returns but may find the reverse unbearable and be prone to sell out at the bottom. Also popular is 'downside capture', which compares a portfolio's returns to that of the benchmark in months when the equity market has declined.

Both volatility and downside capture have intuitive appeal but fall well short of getting to the heart of investment risk. On both measures, cash would be considered very low risk; but while cash is not volatile and never declines in value, it is highly risky. Due to the corrosive nature of inflation and tax, there is no surer way to see the purchasing power of your capital eroded over an investment cycle than by holding cash.

Stocks that hold up well during market sell-offs may satisfy a definition of low risk based on downside capture but prove to be reliably poor investments. Let's look at the last three major market declines: the GFC in 2008–2009, the 'taper tantrum' in late 2018 and COVID-19 in early 2020. The three best performing sectors in each of these periods outperformed the market by

an average of 12% during the sell-off. But in the following 12 months, each one of these sectors underperformed, lagging the market by an average of 25%. In the early 2020 market decline, for example, the three best performing sectors were Telecoms, Consumer Staples, and Health Care. They beat the benchmark over that period by 9%, 10% and 7% respectively, but underperformed in the following 12 months by 42%, 38% and 26%.

In my view, investment risk is best thought of as the permanent loss of a material portion of one's capital. This risk will be a function of three things:

1. the severity of loss, or magnitude of a single stock's decline;
2. weighting, or the percent of portfolio capital committed to a losing position; and
3. the frequency of losses, or the number of losing positions as a percent of total positions held.

A fund may suffer severe price declines of stocks with large portfolio weightings but with low frequency. Or it may have a high percent of its portfolio holdings suffer small losses – individually not material, but collectively very costly. Both cases represent permanent loss of a material portion of capital. However, in neither case will the risk necessarily be captured when measured by portfolio volatility, nor, indeed, downside capture.

This brings me to the subject of portfolio concentration. In Aoris's case, we hold just 15 positions, which in the eyes of some observers constitutes high risk. The portfolio capital committed to any losing position will be material, as our average position size is 6.5%. But we must also consider the other two factors, the frequency and severity of losses. I believe that portfolio concentration, as we apply it, is a source of risk reduction. Owning few businesses allows us to apply exceptionally high standards in terms of both business quality and valuation. It also permits us to be unusually patient in researching and understanding a business that may one day be selected for our portfolio. I believe both the low frequency of losses from stocks owned by Aoris and our record of avoiding severe losses are a testament to our low-risk investment approach.

While I believe our approach to be low risk, I know we will inevitably make investment mistakes and we work hard each year to identify and learn from them. Our investment errors in 2021 were mostly ones of omission rather than commission. Every year, there will be some handwringing over stocks we should have owned but didn't. In 2021, these misses largely stemmed from underestimating the very strong earnings growth over the pandemic period of a handful of businesses on our reserve list. The lesson here is that while history is always a useful guide, profit margins and growth rates for a given business don't necessarily revert to trend and a highly unusual event, such as COVID-19, can make lasting changes to a company's earnings power.

Why I have no view on equity market valuation

Many equity fund managers have an opinion, often strongly held, on whether the stock market in aggregate is cheap or expensive. If the market is viewed as being too pricey, the manager may increase the cash weight in their portfolio with a view to buying back into equities at lower prices. While conceptually appealing, history shows that attempting to profit from the market's zigs and zags along its upwards journey is far more likely to detract from investment returns than add to them.

I have no view, positive or negative, on the value or the direction of the equity market in totality. I do, though, have a considered view on the value of each of the 15 companies we own, as well as all those on our reserve list. I believe the value of the 15 companies we own is rising at a rate of around 10% p.a. To hold \$1 of portfolio capital in cash and eschew the opportunity to have it invested in one of our companies in the expectation that the share price may fall 10% or more from an already attractive level would not be judicious. Our approach at Aoris is to invest effectively all our portfolio capital in the businesses we own, allowing our clients to participate fully in their growth in value and hold as little in cash as is prudent.

As well as overestimating their ability to profitably time the market, allocators of investment capital often suffer from the fallacy of composition, meaning they believe that what is true of the whole is also true of all the component parts. Having formed a view on the equity market in totality, they project this view onto all equities. Thinking about equity market indices and averages misses the dispersion of stock returns within an index. The returns from any individual security will look nothing like the average. To illustrate this dispersion, in 2021 the returns of the best 20% of the global equity market exceeded those of the worst 20% by almost 90%.

What matters is what you own, which in our case is 15 businesses. The index is mostly made up of businesses we don't own. I've seen many poor investment decisions made as a result of confusing these two constructs. Over an investment cycle, the returns from a stock portfolio such as ours will be largely a function of the change in value of the businesses we own over that multi-year period. The degree to which they were purchased below their intrinsic value will also contribute to returns, albeit in a minor way.

The 2021 year for Aoris as a business

For Aoris, 2021 was another year of good growth and progress. The value of funds we manage for clients increased from \$342 million to \$604 million. We strengthened our investment team with the addition of Alfred Tadros as a portfolio manager. Alfie, as he likes to be known, has 14 years of global equity investing experience, most of which was spent in London. He brings intellectual curiosity, a love of learning, equanimity, a commitment to personal health and fitness, and a passion for Arsenal Football Club that at least matches my own!

COVID restrictions once again prevented us from spending a day of in-person community service. This is something we want to institutionalise as an annual event, and I look forward to reporting to you next year on a successful day of helping those in need during 2022.

The year ahead

Your 2022 will likely begin with joy from festive time spent with loved ones, relaxation from a long-overdue vacation, well-intentioned resolutions after some seasonal indulgences, and an inbox full of economic and market forecasts from various financial commentators. Treat these predictions with caution. It is human nature to be drawn to crystal balls; it defuses the anxiety that comes with uncertainty. However, the future is unknowable, and we simply have to make peace with that. In equity investing, living with uncertainty is much easier when we realise that much of what most market participants and commentators fret about, such as election outcomes and monetary policy, have very little bearing on long-term returns.

As I look at our portfolio today, the majority of businesses we own meaningfully improved their competitive position, earnings power and intrinsic value in 2021. Our portfolio companies enter 2022 from a position of operational, financial and competitive strength. Should 2022 prove to be another testing year, we expect the companies in our portfolio to further widen the gap with their peers.

So, we begin 2022 as we begin every year, feeling both cautious and confident. I am cautious, aware that after several years of strong growth and equity returns, expectations from many investors are elevated. I am confident that through owning a concentrated portfolio of exceptional businesses, which we expect to become progressively more valuable over time and with a low risk of disappointment, 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 2022.

Sincerely,

A handwritten signature in black ink that reads "Stephen". The signature is fluid and cursive, with a large, stylized 'S' at the beginning.

Stephen Arnold
Chief Investment Officer

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A COMMONSENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE

Important Information

This report has been prepared by Aoris Investment Management Pty Ltd ABN 11 621 586 552, AFSL No 507281 (Aoris), the investment manager of Aoris International Fund (Fund). The issuer of units in Aoris International Fund is the Fund's responsible entity The Trust Company (RE Services) Limited ABN 45 003 278 831, AFSL Licence No 235150. The Product Disclosure Statement (PDS) contains all of the details of the offer. Copies of the PDS and target market determination are available at aoris.com.au or can be obtained by contacting Aoris directly.

Before making any decision to make or hold any investment in the Fund, you should consider the PDS in full. The information provided does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial adviser if necessary.

You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.