Constantia Investment Partners

Quarterly Note

3rd Quarter 2020

Dear fellow investor

A month can feel like a long time in markets, particularly when sentiment begins to turn negative. As we wrote in our August update, we expected the relentless upwards grind of equity markets to finally meet with the somewhat less sanguine reality of economic conditions on the ground, resulting in a period of volatility and consolidation. September has not disappointed.

Technology businesses – whether classified as such by index providers or using a broader definition – have borne the brunt of the selling this month, with some businesses off between 10% - 15% from their highs achieved in early September. While the swings in the market value of these businesses generate a lot of headlines, it should also be put into context: many are still up more than 20% (and in some cases, much more) for the calendar year to date, even after the pullback.

We continue to think that a combination of lower interest rates and demand pull-forward are informing the market valuations for most technology businesses, and that not all price moves are purely speculative. With that said, we remain selective and look to ensure the Fund is diversified across businesses with exposures to end-markets beyond technology.

With COVID cases in the northern hemisphere again beginning to increase, we cannot discount the possibility of new rounds of lockdowns being put in place, though we think such actions will be more targeted than in March, April and May. To this end, we still believe the idea of a phased recovery – with gradual improvements in economic conditions as the health care risks are bought under control– remains the most likely outcome.

Outlook

As the world works its way to the end of 2020, the outlook remains cloudy. Governments and central banks are certainly committed to getting their economies and populations through to the post-vaccine world, but the eventual cost of this stimulus will most likely come due in the form of higher taxes and a somewhat higher level of inflation.

Rather than trying to predict macro-economic conditions, our focus is on our businesses, their ability to withstand periods of distress, and their competitive positioning coming out of the recession. If there is a period of increased inflation, we believe that owning businesses with pricing power is important. Equally, businesses that benefit from the increased dollar-value of spending (such as payment networks) provide a natural (if imperfect hedge) as their revenues are to some extent determined by the value of transactions processed.

It is still too early for markets to declare victory over COVID. There remains a lot of uncertainty about the timing and efficacy of a vaccine, and the pace of the economic recovery. Until this issue is resolved, we cannot imagine volatility will be far away, despite the relatively benign markets we have experienced from April until September. The spectre of renewed lockdowns to halt the spread of COVID-19, upcoming US elections, simmering geo-political tensions, Brexit, and latent fault lines between EU member states provide no shortage of reasons over which markets could sell off.

Ultimately, our approach is fairly straightforward. We assess businesses for their financial strength, competitive advantage and industry structure. If we believe a business meets our quality criteria, we are patient in deploying capital, but once added to the portfolio, we intend to be long term holders and not actively trade the portfolio. Thus, if the holdings of the Fund look largely unchanged from month to month, it is because we assess our current portfolio of businesses as well capitalised and competitively advantaged, with ample opportunities to redeploy capital at attractive marginal rates of return. We only sell out of a business if we believe our investment thesis has been proven incorrect, or when we cannot reconcile the embedded growth expectations with our estimate of intrinsic value.

We prefer to use volatility to our advantage, but the pullback in September did not provide us with the proverbial slow half-volley outside the off stump we are looking to drive through the covers. As such, we are keeping some powder dry heading into the final quarter of the year.

Performance to 30 September 2020

	GHCF	**Benchmark**
Financial Year 2021	+5.8%	+3.7%
2020 (Calendar YTD)	+10.4%	-0.3%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+16.3%	+6.0%
Annualized Since Strategy Inception	+14.9%	+5.5%

Total returns shown for the AIM Global High Conviction Fund have been calculated using exit prices after taking into account all the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation. Past performance is not indicative of future performance. Benchmark is MSCI World Net Total Return in AUD (source: Apex Group.)

Conclusion

As is customary, you can find at the back of this note the addendum containing our quality scorecard, internal sector allocation, geographic revenue exposure, and the top ten holdings.

We thank you for your ongoing support in what has been a turbulent year. Your trust means a lot to us, and we do not take it for granted.

If you have any questions or would like to have a personal discussion on any aspect of your investment, please do not hesitate to get in touch. We would be happy to arrange a personal call or meeting, as is most convenient.

Kind regards,

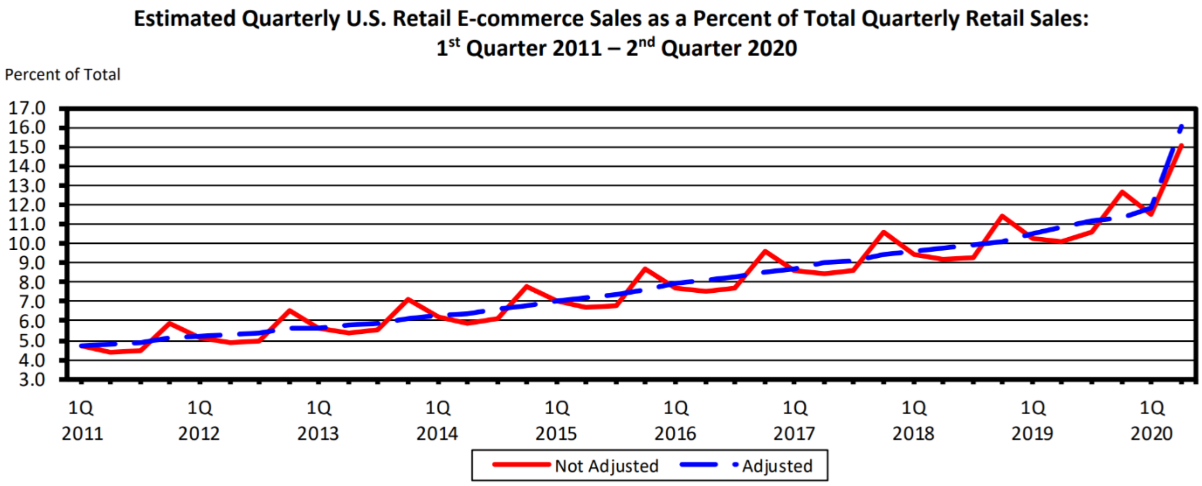
The investment team

Stock Insight: Amazon, volatility, and the virtue of patience

by Etienne Vlok

At this point, saying that ecommerce is a long-term trend with substantial scope for further consumer adoption feels like stating the obvious. However, the noteworthy thing is that this 'obvious' statement has been true for all of the last decade, based on the low penetration of ecommerce as a percentage of addressable retail, particularly in the US.

The graph below shows the US Department of Commerce's estimate of quarterly e-commerce sales as a percentage of total retail sales; this is estimated to be around 15% as at the end of the second quarter of 2020, coming from roughly 5% in the first quarter of 2011. Note the spikes in the red line occurring every year during the Christmas shopping season, which informs the general upwards trend in the seasonally adjusted blue line.



While one can argue with the precise definition of 'retail sales' and whether the 'actual' penetration is higher or lower, we absolutely think the trend illustrated by this chart is correct.

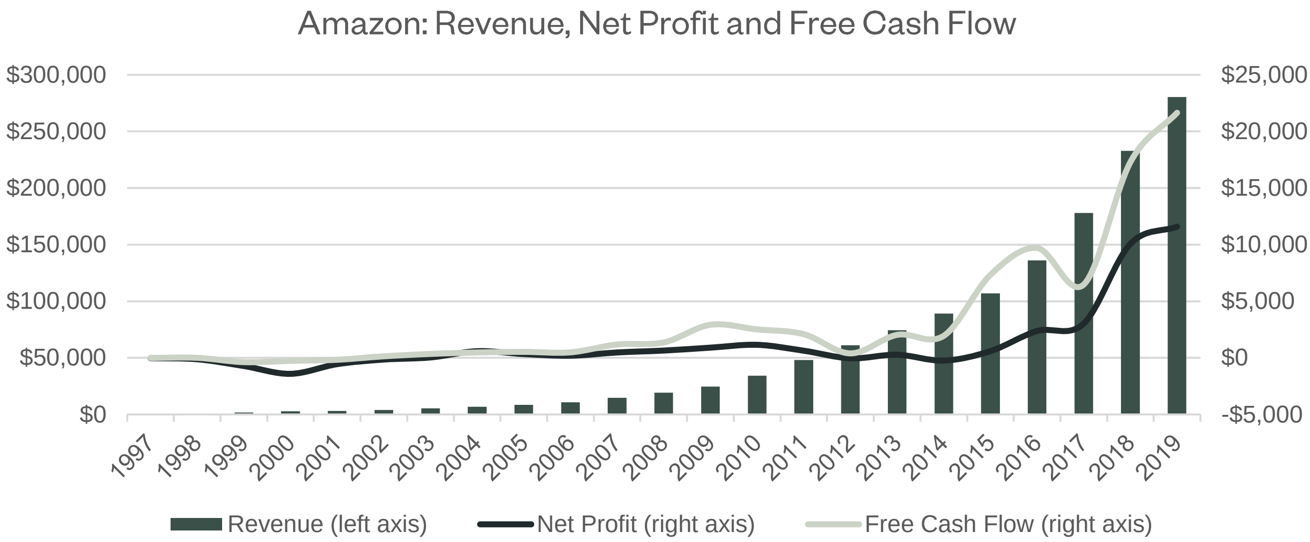
Amazon has clearly been one of the main beneficiaries of this trend, but it has rarely looked cheap (using the traditional P/E ratio) at any point over the last decade. Looking at Amazon in 2010 (essentially, coming out of the GFC, but no longer seen as a dotcom-style fly-by-night business) the stock traded on an average forward P/E multiple of 44.1x (minimum: 32.3x, maximum: 54.4x, median: 43.7x), suggesting a very expensive business to those only focused on earnings.

Interestingly, in the very first Amazon shareholder letter (reviewing the performance of the business for 1997), Jeff Bezos wrote under the heading "It's All About the Long Term":

When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.

We believe that a focus on cash flows rather than accounting earnings is the correct way to evaluate a business, as this is the primary driver of intrinsic value. Seeing management agree on this count is always a tick in their favour, from our perspective.

On that basis, how does Amazon's free cash flow compare with its accounting profits over time?



The chart above shows Amazon's revenues – measured on the left-hand axis and indicated by the black bars – against net profit and free cash flow (defined here in its most basic form: cash from operations less capital expenditures) on the right hand axis. All amounts are in millions.

As can be seen, Amazon's cash flows have been higher than its accounting earnings for a long time. Admittedly, this is partly due to Amazon using stock-based compensation to reward staff. (As a practical matter, we believe free cash flow should be adjusted for this expense, even though it is technically a 'non-cash' item.)

To the investor focused only on the P/E ratio, the fact that Amazon was generating meaningful positive cash flows would not have been clear. Also, keep in mind that free cash flow (FCF) is a measure calculated after the investment requirements for both working and fixed capital has been satisfied, meaning some percentage of the cash generated has been reinvested in future growth. If Amazon were satisfied that it had saturated its end markets and had limited reinvestment opportunities, the investment in future growth would be scaled back, meaning the 'steady state' cash flow generation would be higher.

Thus, despite always having a 'high' P/E ratio, shareholder returns in Amazon have been strong. The chart below measures the price from 31 December 2009 to the end of September 2020 (the black line, using the left hand axis): a $1,000 investment has turned into an astonishing $23,407, meaning a compound annual rate of return of ~34%.

It also shows the forward P/E and P/FCF ratios (the red and beige lines) on the right axis. The P/E ratio peaked at a staggering 881x in February 2015, whilst the P/FCF ratio was at an elevated (but much less optically shocking) 61x at the same time. (This marked a year of intense investment for Amazon.) However, the simple forward P/FCF multiple has generally traded in a much lower range over the past decade, and even as low as a mid-20s multiple on several occasions. We acknowledge that using the most basic definition of free cash flow is too simplistic, but it illustrates the point we are trying to make: by only focusing on earnings, one has arguably missed several opportunities where the stock presented an attractive discount to intrinsic value at several points over the last decade.

That is not to say the ride has been smooth: the stock has been volatile. Since 2010, the stock suffered a drawdown of 10% or worse on more than 20 occasions, and a 20% drawdown on 9 occasions, by our calculations. (Put differently, as an Amazon shareholder, you were faced with a 20% drawdown almost once per year over the last decade). The ugliest decline, peak to trough, came in the final quarter of 2018, when the stock fell by roughly 34%. In fact, during the March 2020 market crash, the stock fell by roughly 22% (and quietly in September 2020, by roughly 16%.)

So, what to make of all these data points?

Firstly, we must deal with the reality that volatility is the price investors are required to pay for long-term returns. If one considers where 10-year government bond yields are at present – and the impact this has on discount rates –volatility is likely to remain high, as minute changes in forecasts or terminal growth assumptions can have a huge impact on price.

Secondly, having the patience to take a longer-term view can lead to greatly beneficial outcomes. There are structural and behavioural reasons why the market is frequently myopic when it comes to incorporating longer-term information into prices, largely to do with the incentives of many market participants looking to maximise short-term performance. Renowned US investor Pat Dorsey – who has added substantially to the body of literature on the economic moats of businesses – points out that being able to take a view on cash flow two years out is often enough of a ‘variant perception’ (relative to the market focus on quarterly revenues and earnings) to generate outperformance; he calls this effect ‘time-horizon arbitrage.’

Finally, it reminds us that taking a business owners’ perspective is – in our humble opinion - the surest path to generating acceptable returns for our investors. What ultimately leads to value creation is the width of a business’ economic moat, how long that can be sustained, and how much cash the business can generate while it is in this position of competitive advantage. While the strength of the moat frequently shows up in a high return on invested capital, this is by necessity backwards looking; all the value creation (which depends on whether the moat is widening or at least being maintained) lies in the future. This must be qualitatively assessed.

We fully concede that picking Amazon to illustrate these points is done with considerable hindsight bias. As with most things, it looks both simple and obvious in retrospect. However, as an investor it is important learn continuously, and if the last decade has taught us anything, it is that the patience to let the compounding effect take hold, and the ability to live with the inevitable periods of market volatility is critical. As long as the businesses we own are well-managed, well-capitalised, operating in attractive markets, and reinvesting in widening their economic moat, it patience pays off.

How has Amazon seen its retail end markets develop during the times of COVID-19?

According to the US Department of Commerce, ecommerce grew by 44% year-over-year in the second quarter of 2020, the fastest rate since 2000, increasing eCommerce’s penetration to 15.1% of total US retail. In the case of Amazon, we believe the pull-forward in ecommerce demand will prove sustainable. We believe that certain categories of retail that have benefitted disproportionately from COVID – home furnishings or consumer electronics, for example – will see some return to physical stores once the world normalises, as consumers will likely still prefer to experience these goods first hand before purchase. Moreover, for these categories, the requirement of a repeat purchase next year is somewhat less likely, meaning that by the time consumers are again in the market for a new TV or sofa, physical retail settings are likely to be much more viable. Add to this, the surge that occurred for goods related to setting up a home office as the pandemic initially spread is unlikely to recur, and it is entirely feasible that growth in some of these ecommerce verticals may be weak in the 2021.

Conversely, smaller, repeat purchases – for example, in grocery or personal care categories – are much more likely to become part of the habitual household spending that shifts online. Food-and-beverage was the fastest growing US eCommerce vertical, growing 220% year-over-year in the second quarter. We believe the initial barrier of filling the weekly grocery basket online for the first time has been overcome by many consumers, and the convenience of conducting the weekly grocery shop online will see them continuing to do so.

To provide some context, the initial July data in the UK from the Office for National Statistics has shown the increase in penetration for online groceries shopping has remained elevated, whilst total online spending has started to normalised somewhat: down to 28% from 33% at peak (but still much higher than in January 2020).

The biggest risk we see for Amazon's retail businesses lie in the huge amount of capital that is currently being invested into 'solving' logistics for ecommerce, whether by direct rivals (such as Walmart) or other internet based ecommerce platforms (like Shopify) or 3rd party logistics providers. COVID-19 has forced all retailers to shift online, whether they wanted to or not, meaning consumers suddenly have a lot more choice than pre-pandemic.

When thinking about the capital cycle, the time of a step-change in supply often leads to increased competition; with all the logistics capacity being bought onstream, rivals with different business models could conceivably make inroads in aggregating some of the demand that Amazon would otherwise have 'naturally' captured over time. We are closely monitoring this dynamic.

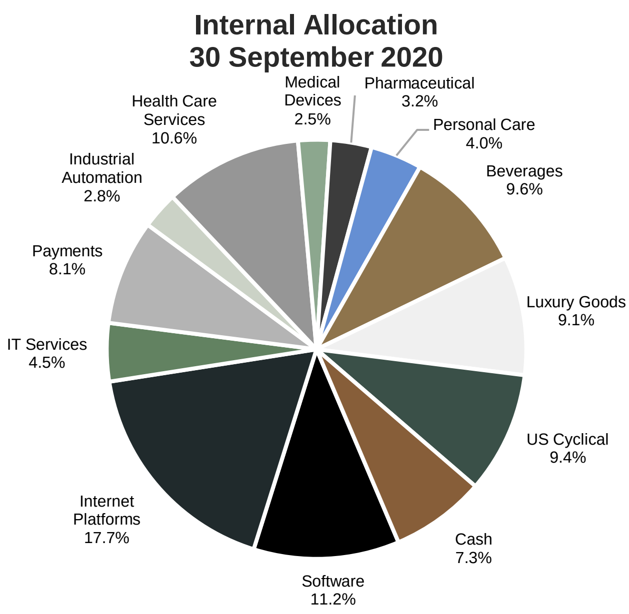
For now, we believe Amazon is still well positioned to capture this change in spending habits, whilst also retaining a huge amount of pre-pandemic online spending. We believe Amazon's lead in logistics provide it with a powerful moat in online retail, and it remains well positioned to 'solve' its customers desire for speedy delivery more efficiently and profitably than almost all of its competitors. With that said, after a stellar run-up in the 2nd quarter of 2020, the position has been scaled back to reflect our assessment of risk and reward, which we see as balanced at current prices.

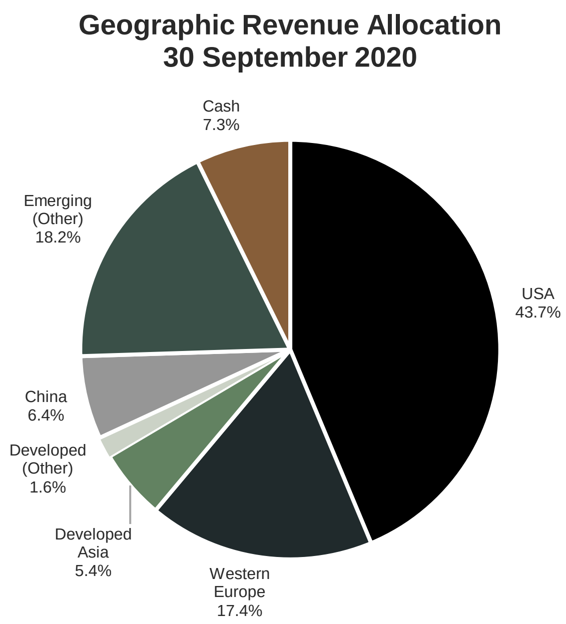
ADDENDUM

Quality Scorecard

Portfolio Characteristic	
Profitability	
Gross Margin	50.2%
Operating Margin	19.5%
Free Cash Flow Margin	16.8%
Returns on Capital	
Return on Assets (ROA)	13.1%
Return on Equity (ROE)	27.4%
Return on Invested Capital (ROIC)	19.3%
Leverage	
Debt/Equity	69.8%
Net Debt/Equity	23.9%
Valuation	
Free Cash Flow Yield	2.7%
12m Forward Free Cash Flow Yield	3.0%
24m Forward Free Cash Flow Yield	3.6%
Holdings	
Number of positions	21
Active Share	86.9%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
accenture	IT Services
Alphabet	Internet Platform
Berkshire Hathaway Inc.	US Cyclical
Coca-Cola	Beverages
ICON	Health Care Services
mastercard	Payments
Microsoft	Software
	Luxury Goods
salesforce	Software
UnitedHealth Group	Health Care Services