Constantia Investment Partners

Annual Letter
2020

Dear fellow investor

2020 has been a decidedly difficult and strange year. If you had asked us a year ago 'what concerns are top of mind?', we would not have put 'living through a global pandemic' high on the list.

The measures required to deal with the spread of COVID-19 have led to widespread job losses, and robbed us all of the enjoyment of normal social interaction with family, friends and colleagues. Of course, this does not even consider the actual human cost of lives lost to the virus itself.

As such, we sincerely hope this letter finds you and your loved ones well, and that you have weathered the challenges of 2020 in good health.

Performance to 31 December 2020

	GHCF	**Benchmark**
Financial Year 2021	+9.4%	+9.7%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+20.3%	+12.2%
Annualized Since Strategy Inception	+14.8%	+9.0%

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.)

Lessons Learnt in 2020

2020 tested market participants like few years in recent memory. As we stand at the end of the year and reflect on the unique investment environment we had to navigate, we believe there are several lessons to be learned.

- **Stay invested.** Tempting as it was to exit markets in March, there were simply too many opportunities on offer to raise cash and move to the sidelines. The saying 'time in the market rather than timing the market' is very true.
- **Volatility is not the primary risk to the patient, long-term investor. It is the psychological cost of long-term returns.** Short term share price movements provide opportunities to buy quality businesses at attractive prices. We manage risk by focusing on the possibility of a permanent loss of capital, not short-term price volatility.
- **Beware over-reliance on macro-economic forecasts.** Focusing on business-specific risks was much more important than trying to guess the next unemployment number or GDP print.
- **Avoid overtrading.** While our portfolio activity this year was higher than what we would consider normal, we created more value by hanging on to high-quality businesses.

- **Stick to our circle of competence.** We very quickly realised we had little value to add in predicting the trajectory of COVID cases or the timeline of a possible vaccine. We tried to learn as much about these subjects as was relevant to where we felt we could add value: analysing businesses for risk, trying to understand changes in consumer or business spending, finding mispriced opportunities, and deploying capital.

Our Annual Letter

This Annual Letter is divided into three parts. The parts are independent of each other and can be read in any order, though we have presented it in a way we feel is most logical.

- Part One provides an overview of our performance for the year.
- Part Two discusses our view on how being overly reliant on macro-economic forecasting can leads on astray when it comes to managing true risk
- Finally, in Part Three, we provide some concluding thoughts on where we see risk for markets from here.

At the back of this letter, we provide an addendum that contains information about the holdings in the Fund:

- a look-through view of the quality characteristics of all the businesses we own (which we refer to as our 'quality scorecard') intended to give you some comfort that we are indeed owning a portfolio of high quality businesses on your behalf;
- a sector breakdown of the businesses we own
- a breakdown of where our businesses generate their revenue (which we consider more relevant than where they happen to be listed)
- the top ten holdings as at year end.

We plan to provide this addendum at the end of all letters going forward, with the goal of providing you with a way to track whether we are true to label over time.

Conclusion

We would like to take this opportunity to thank all investors – new and long-standing – for your support during 2020. We do not take it for granted, and are very grateful for your commitment to the Fund in what was a very volatile year.

Our goal is to compound your wealth over the long-term by sensibly allocating the capital you have entrusted to us.

We wish you and your loved ones a happy, prosperous (and decidedly more normal) 2021.

Kind regards,

The Constantia investment team

Part One: Portfolio Manager's Review

by Etienne Vlok, Portfolio Manager

For the calendar year ended 2020, the AIM Global High Conviction Fund (GHCF) delivered a return of +14.18% after all fees. This compares to a benchmark return of +5.58%.

The table below breaks down the Fund's return for all four calendar quarters as well as the full year. Breaking down our 2020 return profile by quarter is instructive, as it demonstrates how and when we believe our quality-focused strategy will outperform.

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	2020
AIM Global High Conviction Fund	-2.5%	+7.0%	+5.8%	+3.4%	+14.2%
Benchmark	-9.3%	+6.1%	+3.7%	+5.9%	+5.6%

In brief, we believe that our strategy should hold up better during periods of market distress due to our focus on balance sheet strength. Following a market crash, our preference for cash producing (and cash-rich) businesses should generally see us perform well; however, when the crisis abates and the next cyclical rally starts, we will likely only match (or possibly lag) the general market index for a period. As the business cycle matures, we expect our businesses to outperform due to the intrinsic competitive advantages allowing them to compound their internal pool of capital at a high rate of return. In our experience, excess returns (also referred to as 'alpha') are typically earned unevenly and unpredictably over time, which is why we believe that time in the markets allows the patient investor to capture this alpha by staying the course through these cycles.

If you study the table above, you will note that the expected return profile outlined is indeed the pattern we managed to deliver: outperforming markedly in the March crash, achieving modestly better returns over the second and third quarters, and then lagging the market slightly in the final quarter as the news of vaccines being approved kicked off a rally in more cyclical assets. If there is anything odd about this year, it is that this pattern played out in the space of only ten months. Normally, a market recovery would take longer. The thanks (or blame, depending on your view) for this rapid recovery can in large part be laid at the feet of the massive amounts of monetary and fiscal stimulus deployed by central banks and governments this year.

Over a full economic cycle, we think our strategy will be able to produce a fine result, but we do not expect to be able to outperform markets every month, and we certainly do not position the Fund to try and do so.

Currency Impacts

Staying unhedged to global currencies did a lot to soften the blow to absolute performance in March, when the AUD weakened substantially. However, from then onwards, it has been one-way traffic in the other direction. On the whole, the currency functioned as an effective 'safety valve' of sorts – on days when global equity markets weakened, the currency mostly did the same (to our benefit). However, there is no getting around the fact that over the full year, AUD strength meaningfully detracted from our underlying equity returns. We estimate that the absolute performance of the Fund's was reduced by roughly 11.2% as a result of currency headwinds.

To illustrate this dynamic a bit more practically, consider two businesses that we invested in around March and April:

- Our stake in Japanese vision sensor specialist Keyence was mostly acquired in March at prices around JPY31,000, and we modestly added to it in August around the JPY42,000 level. The business ended the year trading at a price of JPY58,000. Adjusting for the weighted purchases prices, our total return in Japanese Yen was around +78.4%, but only +50.5% in AUD due to the dollar strengthening relative to the Yen since March.
- The same occurred for our position in Berkshire Hathaway: the bulk of our buying occurred around USD175 in March and April, with an additional tranche around USD170 in mid-May. The business ended the year trading slightly below USD232, bringing our weighted total return in US dollars to roughly +31.8%. However, this was reduced to only +4.6% in AUD due to currency strength since our point of purchase in early 2020.

We should point out that a very meaningful component of the strength of the Australian dollar played out in November and December, meaning that our 4th quarter returns were most significantly impacted by this factor.

While we are cognisant of the impact that currency movements can have on the returns over the short-term, we manage this through appropriate diversification and position sizing in the Fund. Our primary focus remains on investing in quality businesses that can sustainably compound returns over the long term.

Part Two: The Risk of Over-Reliance on Macro-Economic Prediction

by Etienne Vlok, Portfolio Manager

Normally, we would provide some macro-economic prediction about what might happen over the next year or so. We will refrain from doing so in this letter and in all future letters, since 2020 has quite dramatically demonstrated to us how futile such an exercise really is.

We went from publishing a ‘2020 outlook’ in January of last year to having to tear it up only six weeks later. Market commentators in March and April were forecasting doom, and yet global risk assets delivered a surprisingly good return, given the underlying economic disruption. In a year with a massive range of potential economic outcomes, investors were essentially forced to operate without a script, with all forecasts becoming ‘best guess’ attempts (our own included.)

We think providing highly specific macro-economic forecasts create an illusion of false precision for ourselves and investors. The fact that we have completed another orbit around the sun does not make a 2021 forecast likely to be any more accurate. As economist John Kenneth Galbraith once remarked about his own profession, ‘the only function of economic forecasting is to make astrology look respectable’.

With that said, we definitely make forecasts about the future cash flows of the businesses we own, although here we think our fundamental analysis at least enables us to be more informed when doing so. However, no amount of imagination or scenario analysis can predict or forecast every possible future outcome, good or bad. So, what to do?

We believe our focus should be on constructing the Fund to be robust and resilient to unexpected shocks. There will always be the risk of unforecastable high impact events, of which the 2020 pandemic is a prime example. Technology businesses were not only anti-fragile to a pandemic, but they were also part of the solution to help our economies continue to function. At the risk of sounding pessimistic, there is no guarantee that the next crisis does not cripple the global technology infrastructure: how much ‘tech’ would you want to own then?

Our goal is to ensure the Fund is not a one way bet on any specific scenario or theme, and rather than being highly optimised for only one outcome, is prepared to weather a range of outcomes. When it comes to macro-economic conditions, our motto is ‘prepare, don’t predict.’

This explains why we focus so heavily on owning businesses with very robust balance sheets. When an unexpected crisis occurs, leverage combined with a lack of readily accessible cash reserves is the most direct path to a liquidity crunch, with potentially dire consequences for equity owners. We may miss out on opportunities and lag somewhat in a bull market, but we do not think relaxing this criterion is a great way to compound capital over the long term.

In place of making any macro-economic or market predictions, we will outline what we think are the main risks over the medium term, and how we are addressing them in the Fund.

Part Three: The Risk Unexpected Inflation & Higher Interest Rates

by Etienne Vlok, Portfolio Manager

Many market participants are forecasting an increase in inflation over the next several years due to the vast amount of monetary and fiscal stimulus provided in 2020. In fact, central banks are telling markets they are willing to let inflation 'run hot' to achieve a level of average inflation above 2% over a period of time.

In and of itself, modest inflation (say, 2% to 4%) is not the end of the world, provided you own productive, real assets. With cash yields likely anchored close to zero for an extended period, we believe having too much capital allocated to cash is almost guaranteed to earn a negative real return for some time. (As an aside, we do not find this attractive, and therefore intend to stay within our 90% - 100% equity allocation in the Fund. You do not pay us to sit on cash, and we are not an asset allocation vehicle. If you entrust your capital to us, we will operate under the assumption that you want it managed in line with the equity-centric process and philosophy we follow.)

It is important to understand there will be an acceleration in reported year-over-year inflation from April to June of 2021. This acceleration will not necessarily be because inflation is shifting structurally higher, but because there was *disinflation* (positive but slowing inflation) in April to June of 2020 as economies went through the worst of the lockdown. To oversimplify: because inflation was very weak in the second quarter of 2020, merely normalising to something closer to pre-lockdown levels in the second quarter of 2021 will mathematically look like a meaningful year-over-year acceleration. Do not be surprised if there is a lot of ink spilt on rising inflation during the second quarter of 2021.

The belief that inflation will run hot for some time is the basis of the 'reflation' trade many people are recommending: own commodities and banks, who a) have short duration cash flows, b) trade at cheaper starting valuations and c) will show tremendous year-over-year growth in earnings in 2021 (due to earnings collapsing in 2020) and d) will benefit from modestly rising interest rates.

If the extent of the pick-up in inflation is a spike in 2021 followed by an average of 2% - 3% thereafter, we are not overly concerned about our holdings. The stocks we own may underperform for a period as they go out of favour, but the underlying businesses we own should do just fine.

However, focusing on a short-term increase in inflation misses the greater point. The true risk we are concerned about is whether inflation will move materially higher (say, to well above 4%) for an extended period, to the point where central banks need to raise interest rates to bring it under control. Such a tightening of financial conditions will likely cause no small amount of volatility in markets as liquidity is withdrawn. However, it is important to distinguish between the *business* risk and the *market* risk of inflation.

As 'business-first' rather than 'security-first' investors, we approach this issue from a fundamental point of view. The primary effect of inflation on a business is that it causes input costs to increase in nominal terms. As such, we believe there are two critical questions to ask:

1. Does the business offer a service/product that is sufficiently differentiated to increase prices above the rate of cost inflation without impacting sales volumes? In other words, does the business have pricing power to grow its profits in real terms?
2. Does the business need to reinvest a lot of its profits back into tangible assets to grow and maintain its operations? Put differently, is the business capital heavy or capital light, reliant on physical or intangible assets?

The last time high inflation presented a major problem was in the 1970's and early 1980's. To understand its effect on businesses, there is likely no better source to turn to than Warren Buffett, who successfully navigated this period in markets and wrote about the impact of inflation extensively. Below, we quote the 1983 Berkshire Hathaway shareholder letter, which provides a very succinct summary for why we emphasise the two questions above.

> *For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.*
>
> *In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses.*

Mr. Buffett specifically addressed the issue of pricing power in testimony at a Congressional hearing in 2010:

> *The single-most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by a tenth of a cent, then you've got a terrible business. I've been in both, and I know the difference.*

If central banks are forced to raise interest rates to contain inflation, we think the risk of higher private sector defaults (given the quantum of outstanding debt) would increase materially, meaning banks would be negatively impacted. Also, an ongoing increase in inflation will eventually erode the fundamental profitability of capital-heavy business models (such as commodity producers) who need to replace their physical capital at ever-higher price levels.

That addresses the *business* risk of inflation. However, there is also a *market* risk to address.

Inflation hurts all financial assets to some degree. If interest rates do move meaningfully higher, discount rates for businesses will adjust upwards, with a negative impact on valuations.

Lower discount rates disproportionately benefited high growth businesses in 2020; by implication, higher rates will disproportionately hurt them. Buying or owning any business with cash flows only occurring in the very distant future is therefore not too dissimilar from buying a 10- or 30-year government bond at present yields. (At least the equity has the advantage over a bond of being able to grow its cash flows.)

We do not want to mistake lower discount rates for investment genius (to paraphrase the famous quote about the cause of the global financial crisis of 2008.) Loading up the Fund with a collection of such names is creating the exact type of one-way bet we want to avoid, because it assumes interest rates remain at present levels essentially forever. While we think yields on cash will remain very low, there is a reasonable risk that government bond yields can move higher if global economic growth improves and broadens out.

We do not pretend to know the magnitude of inflation over the next several years. At present, we believe we have a balanced exposure to long-duration businesses that can grow their cash flows at attractive rates of return. We believe these businesses have enduring competitive advantages that will see their operations through periods of rising inflation, even if their stock is volatile for a period if interest rates move suddenly higher.

Our Response to these Risks

As economics professor Elroy Dimson once said: 'risk means more things can happen than will happen'. We believe the best way to protect against the risk of a meaningful and sustained increase in inflation is to own productive businesses that have strong balance sheets, have low tangible asset reinvestment requirements, and possess pricing power: in short, the kind of high-quality businesses we already own.

In addition, we have made a point of owning businesses where the valuation is not exclusively reliant on long-duration cash flows (Berkshire Hathaway), or that benefit from an increase in nominal prices (MasterCard and PayPal both generate a component of revenue based on the dollar value of transactions in their ecosystem).

Our process generally guides us to three types of businesses: dominant consumer brands, scalable platforms/software, and those that provide non-core yet business-critical goods and services.

Dominant Consumer Brands

When well-managed and cared for over a period of years, brand recognition can provide one of the most powerful intangible moats any company can wish to have. However, not all brands create value for their owners. Brands are only valuable when a) they convince consumers to pay more for a specific product/service than for the equivalent, non-branded version, or b) they reduce consumer search costs. Let us briefly address both variants.

- The best brands essentially live rent-free in consumers' minds, with a combination of goodwill, affinity, desirability, scarcity, social signalling and affordability driving purchase decisions. The classic example is jeweller Tiffany: consumers are willing to pay a premium for an engagement ring that comes in the (trademarked) robin-egg blue Tiffany box compared to a ring with an identical diamond purchased from a lesser-known competitor. Brands that impart a societal status on the buyer, user or wearer of their goods are very difficult to disrupt. We look for these attributes in brand-driven businesses, as the buyer appeal can often lead to substantial pricing power over time.
    - Nike, Estee Lauder and LVMH (now the owner of Tiffany) are three businesses in the Fund where we think the strength of the consumer affinity towards their brand underpins their long-term competitive advantage. All three businesses are currently transitioning to the new era of omnichannel retail. The combination of reaching new consumers (who may not live near a store selling the product), building a more direct consumer relationship, cutting out the middleman and rationalising floor space should lead to sustainably higher margins over the medium term.
    - Combined with the abovementioned pricing power, we believe these businesses have the makings of fantastic long-term franchises that can grow cash flows in real terms.
- Search-cost reduction' brands create value because they lower the time consumers need to spend thinking about which product they want to buy. As a simple example, think about how you buy cooking oil when you shop: do you spend five minutes browsing through every bottle in the aisle, or do you simply grab the product from the brand you know and have come to trust? If it's the latter, the brand you prefer lowers your mental cost of having to search and decide: if you trust the quality of the product, you may be more inclined to pay a specific price to acquire it over cheaper or lesser alternatives.
    - Brands that rely on search cost reduction are somewhat more easily disrupted in the days of ubiquitous online advertising. The traditional barrier to competition for businesses using this moat was the substantial marketing cost required to reach a wide consumer audience. Today, challenger brands can more easily catch your eye with affordable targeted marketing through Facebook, Instagram, YouTube, etc.
    - We think Coca-Cola and Heineken are both businesses where the 'search-cost reduction' function is still strong – if you walk into a restaurant in a foreign country (well, when we can travel or go to restaurants again!), you know what you are getting when you ask for a Coke or order a Heineken. During the pandemic, both businesses reported that consumers gravitated towards brands they knew and trusted due to lower in-store browse-times (less time in-store means a lower risk of potential infection), and both businesses reported robust underlying demand in the channels where they could still sell their product.
    - At a stretch, we think Amazon might also qualify as a 'search-cost reduction' brand. Amazon does not always offer the lowest price for every product, but the fact that your order arrives on-time, in good condition, and with a simple refund process means many consumers simply choose Amazon as their first and only port of call when shopping online. This element of trust is not easily replicated.

Scalable Platforms/Software

Many of the dominant technology companies of today fit this description. The most successful firms in this space benefit from an economic phenomenon known as 'increasing returns to scale' – essentially, as they become bigger and more dominant, they become more profitable as the market tends towards allowing only a few competitors. You may choose to join social network A over alternative platforms in order to engage with your friends, and by your very action, network A becomes more entrenched in your social circle. As technology is an industry in a state of relentless development and constant disruption – where yesterday's winner is tomorrow's also-ran – we choose to only own businesses with multiple overlapping and proven moats in this space. High switching costs and strong network effects are what we look for to minimise our risk of being wrong.

- We believe Microsoft, Alphabet, MasterCard, Amazon and PayPal all exhibit some combination of these traits today, and many of the businesses owned by Prosus have the ability to exhibit these traits in future.
- While less obvious, we think UnitedHealth is building (through its integrated Optum business, which offers a care network linked to a health care data & analytics business) a real-world scalable platform for offering value-based care in the US.

Non-Core, Business Critical Goods or Services

These businesses generally benefit from being the tools that enable other professionals to perform their job. As long as the product/service is critical to 'getting the job done', and the cost of said product/service is relatively small in the bigger scheme of things, the efficiency and familiarity of the product/service is more important than being the lowest cost provider, leading to a 'switching cost' moat.

- Though exposed to different end markets, we find these characteristics in portfolio holdings such as Accenture, Fastenal and ICON PLC.

Berkshire Hathaway

Berkshire presents a unique investment proposition in the Fund that is largely uncorrelated to our other holdings. Being more reliant on physical assets, it is exposed to more cyclical sectors such as finance and heavy industry that are not as readily scalable. Suffice to say that the fact that it is different from all our other holdings – yet of exceptionally high quality – provides the Fund with attractive diversification in our view.

In addition, many of Berkshire's underlying businesses do have strong moats and are exposed to a cyclical upswing in the US economy. See's Candy demonstrates both pricing power and brand recognition, whilst the Burlington North Santa Fe Railway owns a near impossible-to-replicate railroad network)

Finally, one of Berkshire's historical differentiators – access to low-cost capital due to the positive returns earned on the insurance float – is less relevant in a world where the cost of capital is at multi-decade lows. Should the cost of capital increase, Berkshire's large cash position – combined with experienced capital allocators at the helm – position it very well. In short, we believe Berkshire offers attractive optionality and diversification for the fund, and it has more than one way to increase in intrinsic value.

In Closing

Our goal is to own competitively advantaged, high-quality businesses that can compound in value over time. As tempting as it may be to try and switch into stocks that may do well for the short run, we know that compounding only happens if you allow it to. Businesses that can stay in the game, have strong balance sheets and can consistently earn high returns on invested capital are the ones with highest probability of finishing the race.

At present, we believe we own a portfolio of businesses that have strong competitive advantages, very strong balance sheets, high returns on capital, and good cash generating ability. This served us well in 2020. If the market decides that it prefers more cyclical or lower-quality businesses rebounding from depressed valuation levels in 2021, we will live with it. Prices vary more than intrinsic values do. We plan to earn our long-term return from the underlying compounding of internal capital of the businesses we own, not in trading their stocks.

The macro-economic landscape is, to some extent, like the weather – we will all have to deal with it. While we cannot mitigate every risk in every business we own, we have structured the Fund to be resilient to unexpected shocks, given the quality of the underlying businesses held.

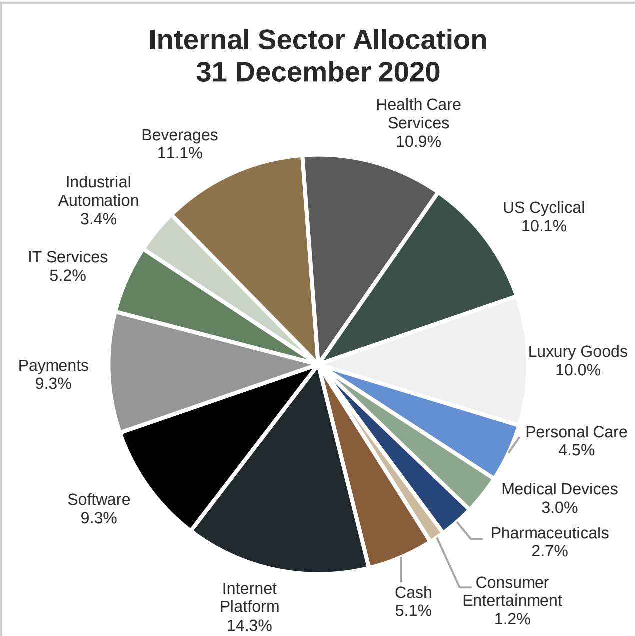
Again, we thank you for your support in what has been a highly unusual year. Your trust means a lot to us, and we do not take it for granted.

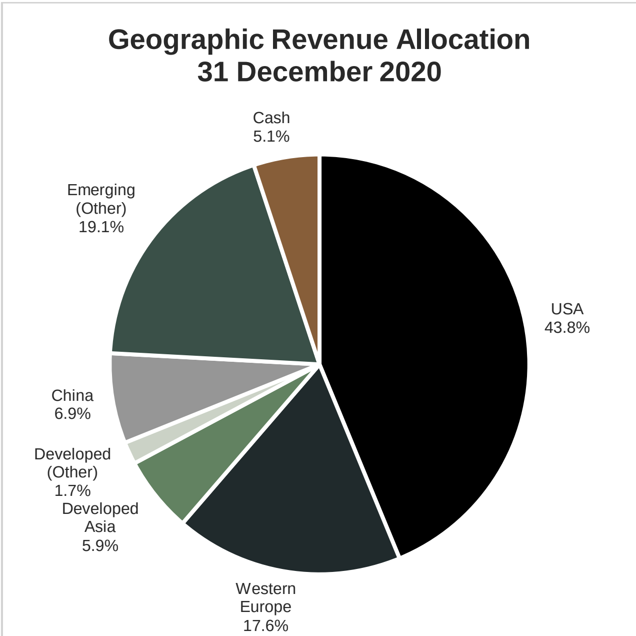
ADDENDUM

Quality Scorecard

Portfolio Characteristic	
Profitability	
Gross Margin	49.8%
Operating Margin	20.1%
Free Cash Flow Margin	17.0%
Returns on Capital	
Return on Assets (ROA)	11.9%
Return on Equity (ROE)	24.9%
Return on Invested Capital (ROIC)	16.5%
Leverage	
Debt/Equity	68.6%
Net Debt/Equity	22.1%
Valuation	
Free Cash Flow Yield	3.2%
12m Forward Free Cash Flow Yield	3.6%
24m Forward Free Cash Flow Yield	4.0%
Holdings	
Number of positions	21
Active Share	87.8%

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
Heineken	Beverages
ICON	Health Care Services
mastercard	Payments
Microsoft	Software
Nike	Luxury Goods
UnitedHealth Group	Health Care Services