Constantia Investment Partners

Quarterly Note

1st Quarter 2021

Dear fellow investor,

The main driver of markets over the quarter was the relentless rise in the US 10-year government bond yield: from 0.92% at the end of December to 1.74% at the end of March. All else equal, higher interest rates drive higher discount rates, making far-in-the-future cash flows worth less than near-dated cash flows. The relatively benign market return over the quarter obscures the sharp rotation from 'growth' to 'value' that occurred under the surface.

We suspect the cause of the rapid rise in bond yields is most easily linked to expectations of higher inflation. We anticipate year-over-year inflation to remain elevated over the next several months as the weakness in the corresponding period in 2020 is lapped; the real question is 'what happens after2021?'. The jury is still out, but we are prepared for several outcomes.

Given the expected economic recovery over the next 18 months, an alternative explanation for the recent underperformance of highly valued growth businesses relates to the fact that there is simply 'cheaper' growth available to buy in cyclically depressed sectors.

Regardless of which narrative the market favours over the short term, our approach will remain the same: to purchase long-term ownership interests of future cash flows in sustainably advantaged businesses with resilient balance sheets at a price that is lower than their intrinsic value. We do not think trying to classify this approach as simply value or growth is accurate: we look for quality compounders, and they can be found in both camps.

Performance to 31 March 2021

	GHCF	Benchmark
Financial Year 2021	+12.5%	+16.7%
2021 (Calendar YTD)	+2.8%	+6.3%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+23.6%	+19.3%
Annualized Since Strategy Inception	+14.3%	+11.8%

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.)

Noteworthy Changes in the Fund

Reduction of ICON PLC

The importance of clinical trials and related services were vividly highlighted by the efforts required to produce an effective vaccine to COVID-19. Our assessment of the medium-term demand outlook for contract research as a key enabler to vaccine and pharmaceutical development is upbeat. As a result, contract research organization (CRO) ICON PLC was a high conviction position in the Fund as we entered the quarter. At ICON's full year results announcement In February, the numbers reported – as well as the outlook for 2021 and beyond – exceeded our expectations. In short, the business was performing in line with our expectations of it.

Simultaneous to its annual results, ICON announced its intention to acquire PRA Health Sciences (PRAH) – a rival CRO of similar size – for an enterprise value of roughly USD12bn, financed using both debt and equity.

While the deal does have a strategic rationale, our assessment is that ICON is paying an at-best full price for PRAH. Much of the synergy of the combination hinges on reducing PRAH's effective tax rate to be closer to Irish-domiciled (and thus tax-advantaged) ICON's effective tax rate. In addition, there are always execution risks with a transaction of this size, not the least of which is cultural and organizational integration between two former competitors. While we understand there to be only modest overlap between the client base of ICON and PRAH, drug companies will want to manage their vendor concentration risk, meaning that 1+1 may not necessarily equal 2 in this case. The transaction will also add a meaningful amount of debt onto ICON's balance sheet from what was previously an industry leading net cash position.

We remain constructive regarding the long-term outlook for the CRO space, but the near-term execution risks and debt load have altered the risk-reward calculus on ICON. Given the somewhat fraught history of M&A in the CRO space, we have reduced our weighting in-line with our increased scepticism over the deal until we have more clarity on the success of the transaction. Realistically, we will only begin to see meaningful feedback on this issue from 2022 at the earliest.

Purchase of Croda International PLC

The Fund has recently invested in British niche chemicals provider Croda International PLC. The business is listed on the London Stock Exchange and operates across Europe, the United States and Asia.

As we have written previously, we seek to invest in businesses that provide mission critical products to their customers. Typically, these products make up only a small percentage of the cost of the goods sold by their clients, but without which the final product will not do what it says on the label. By way of example, selling a hair straightening shampoo requires the key hair straightening ingredient for the product to function as advertised.

Over several decades Croda has built a reputation as a reliable partner to their customers, delivering a consistent product at a high level of quality. Approximately 80% of R&D spend is driven by customer requests, reinforcing the trust and dependence Croda's clients have in the business while simultaneously resulting in a higher efficiency of spend for shareholders. Over time, the business has broadened its product reach to the extent that no single customer accounts for more than 3% of group revenue today.

As a trusted partner to their clients, Croda increasingly enables the tracing of raw material ingredients up the value chain to ensure that a product that is promised as environmentally sustainable from its source to the end-consumer can be verified as such. This is a key point of difference and one that we believe widens the group's moat, enabling them to take market share as customers reformulate their own products to become more environmentally friendly.

One of Croda's largest end-markets is personal care. Online adoption in the personal care market has lowered the barriers to entry for challenger brands in accelerating the speed and ease of bringing new products to market. Croda has been an enabler of this trend, with approximately 75% of its clients being small and medium size enterprises that often slip under the radar of Croda's larger speciality chemical peers. Coupled with Croda's batch manufacturing capacity, this allows for production runs that support the more modest demands of emerging brands while generating healthy margins for Croda.

Croda exceeds the hurdles we typically look for in a long-term compounder. The business has a consistent track record of comfortably generating returns on invested capital greater than the group's cost of capital, coupled with a proven track record of cash conversion that has enabled 29+ successive years of increasing dividend payments.

Businesses providing a low-cost, yet mission-critical product tend to enjoy pricing power, and inherently benefit in a rising inflationary environment. We believe Croda is such a business, meaning it is well positioned to compound at inflation-beating returns for many years to come. In addition, Croda's operations and end markets exhibit a lower correlation to other positions in the Fund. In short, we believe it acts as a diversifier of returns without requiring us to compromise on quality.

Conclusion

The Fund owns businesses that earn substantially higher returns on capital, generated with lower balance sheet risk. In exchange for this quality, these businesses are priced at a premium, though we believe not excessively so.

All else equal, we wish to own businesses that are capital-light – in other words, they don’t need to reinvest a huge amount of capital back into the business to fund future growth. We balance this goal against the price we are asked to pay in acquiring an interest in such a business. Should highly valued technology businesses – several of which saw their business models and end markets prove out over the last year – reset to more reasonable valuations supported by fundamentals, we would be pleased to introduce them into the fund. The key point remains valuation: we are not price-agnostic investors.

The remainder of this letter focuses on the Keynesian Beauty Contest, speaking to why our process focuses on business fundamentals rather than short term market narratives. We also provide the portfolio quality scorecard, sector and geographic revenue breakdown, and top ten holdings in an addendum at the end of the letter.

Kind regards,

Etienne, Les, Dan & Andrew

Avoiding the Keynesian Beauty Contest

by Etienne Vlok

When reflecting on the past year, a notable takeaway for our investment team has been to be mindful of keeping our focus on business fundamentals rather than attempting to profit from whatever narrative is driving the market. This sounds simple enough on paper, but resisting the temptation of falling into this 'narrative fallacy' is quite difficult to achieve in practice – to such an extent that many investors step into this mindset without even realising it.

The reason is deceptively simple: by definition, the vast bulk of *daily* news flow we all consume has almost nothing to do with the fundamental drivers of *long-term* value. Instead, daily news flow shapes the short-term expectations that drive the dominant 'narrative' about markets.

To understand why we believe it is critical for investors to differentiate between fundamentals and narrative, we turn to John Maynard Keynes. Though primarily remembered as an economist, Keynes managed the King's College endowment at Cambridge from 1921 to 1946 (in other words, through the Great Depression and World War II) with great success, delivering a tenfold return over a period where UK markets were essentially flat.

In *The General Theory of Employment, Interest and Money*, Keynes addresses the impact of market expectations on price:

> *The actual, private object of the most skilled investment today is 'to beat the gun'; […] to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.*
>
> *[This] may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view.*
>
> *It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees.*

There have been some fascinating real-world tests that explore this mindset. The *Financial Times* posed the following question to its readers in 2015:

> *Guess a number from 0 to 100, with the goal of making your guess as close as possible to two-thirds of the average guess of all those participating in the contest.*

Suppose there are three participants who guessed 40, 60 and 80. In this case, the average guess would be 60, two-thirds of which is 40, meaning the person who guessed 40 would win.

In theory, a large group of people guessing a random number between 0 and 100 will eventually average out to 50. However, a 'first-degree' thinker would likely reach that conclusion, and then guess 33 (equal to two-thirds of 50). A 'second-degree' thinker might conclude that there will be enough first-degree thinkers to move the average guess closer to 33, so the 'smart' guess would be 22 (two-thirds of 33). The 'third-degree' thinker would guess 15 (two-thirds of 22), the 'fourth-degree' would guess 10 (two-thirds of 15), and so on. (In reality, the average guess in the *Financial Times* puzzle was 17.3, meaning the 'correct' guess was 12).

Carried to its logical conclusion, it becomes obvious that the problem inherent in such a game is that there is a circular reference: each participant's guess alters the outcome, meaning contestants end up trying to guess what the other players might be guessing, and adjust their own guess accordingly. There is no point at which one can confidently get off this train of thought in the knowledge your answer is correct. The concept has come to be known as the Keynesian Beauty Contest.

This concept quite accurately describes a market where the participants stop paying attention to the fundamentals of an asset, but rather attempt to speculate about what other people might pay for the asset at some point in future. Under such conditions, the best ‘narrative’ attracts the most investor interest. Sure as night follows day, inflows follow interest, pushing up prices as new buyers enter the market. Combined with some good, old-fashioned fear of missing out on easy, quick returns (the result of a collection of behavioural biases hardwired into our psychology), this dynamic can lead to prices dramatically disconnecting from the underlying economic value of an asset as more investors crowd into it.

However, the ‘narrative’ is essentially just the consensus opinion constructed from the collective psyche of market participants. When the consensus narrative changes for an asset that has divorced from underlying fundamentals, the outcome to investors can be disastrous – particularly when huge amounts of borrowed money have been involved in bidding up the price. The 2007/2008 US housing market crash (“house prices can only go up!”) that triggered the Global Financial Crisis is a vivid example of what can happen when crowded assets owned by leveraged speculators undergo a material change in narrative.

Our investment process is based on trying to determine the intrinsic value of a business. We believe that discounting future cash flows that can be distributed to the owner of an asset is the best method of determining the intrinsic value for most investments. While acknowledging many of the shortcomings of the discounted cash flow methodology, it has the advantage of anchoring our estimate of value to some sort of economic reality.

Of late, there has been an explosion of interest in non-cash-generating assets where determining a reliable estimate of intrinsic value is nearly impossible. We would point to the meteoric rally in cryptocurrencies, or the sudden interest in non-fungible tokens (NFTs) – essentially, tradable digital certificates that use blockchain technology to prove ownership and origin of digital assets – as examples. (Christie’s recently auctioned off an NFT of the work of digital artist Beeple for USD69.3mn; the image remains freely viewable and downloadable on the internet.) These assets may have utility and even scarcity over the long term, but recent price action seems to us to exhibit all the hallmarks of a Keynesian Beauty Contest.

The behaviour has arguably spilt over to other asset classes and certain pockets of the equity market. Given that capital is essentially free, many market participants are using borrowed money to place leveraged bets on asset prices continuing to rise. We find it noteworthy that there have been several liquidity-driven ‘unwinds’ in markets this year; from publicly available information, massive amounts of leverage were involved every time. We cannot claim to know how any of this will end, but we do know that leverage combined with highly crowded market positioning rarely ends well when an unexpected external event causes forced selling.

When allocating our investors’ capital, we try to understand whether the expectations embedded in the market price of the businesses we own bear at least some semblance to reality when applying a reasonable range of estimates. We try to control for fundamental risk by sticking to businesses that have strong balance sheets and generate meaningful amounts of cash. As the wisdom goes: revenue is vanity, profit is sanity, but cash is king.

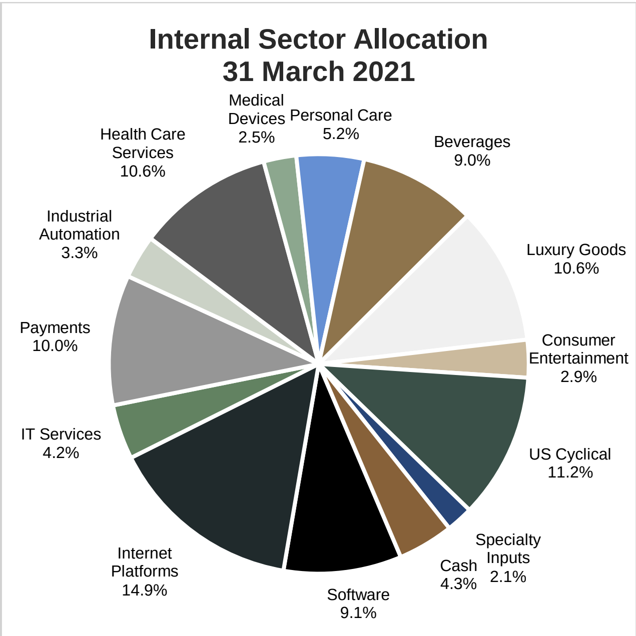
In short, we think sticking to a defined and repeatable process will serve us a lot better than trying to claim the first prize in a Keynesian Beauty Contest.

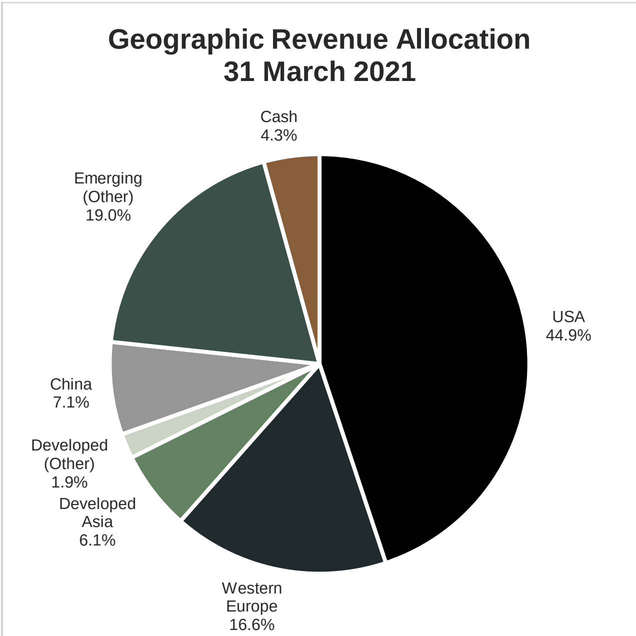
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	March 2021
Profitability			
Gross Margin	55.7%	49.8%	49.4%
Operating Margin	23.5%	20.1%	20.8%
Free Cash Flow Margin	18.9%	17.0%	16.6%
Returns on Capital			
Return on Assets (ROA)	13.0%	11.9%	11.8%
Return on Equity (ROE)	28.3%	24.9%	25.2%
Return on Invested Capital (ROIC)	24.0%	16.5%	15.7%
Leverage			
Debt/Equity	87.2%	68.6%	71.8%
Net Debt/Equity	19.3%	22.1%	22.5%
Valuation			
Free Cash Flow Yield	2.8%	3.2%	3.0%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.4%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.9%
Holdings			
Number of positions	19	21	21
Active Share	86.5%	87.8%	88.7%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
Alphabet	Internet Platform
Berkshire Hathaway Inc.	US Cyclical
Coca-Cola	Beverages
Estée Lauder Companies	Personal Care
ICON	Health Care Services
LVMH Moët Hennessy • Louis Vuitton	Luxury Goods
mastercard	Payments
Microsoft	Software
	Luxury Goods
UnitedHealth Group	Health Care Services