Constantia Investment Partners

Quarterly Note
3rd Quarter 2021

Dear fellow investor

To say the most recent quarter was a tale of two halves would be slightly misleading: more accurate would be to say it was a tale of 13 weeks of relative calm, followed by a final week of elevated volatility.

The last week disproportionately affected several of the businesses owned in the Fund, as the market rotated away from the modestly geared, capital-light and high return on capital businesses we prefer, and into more cheaply valued reflation plays. Energy businesses in particular were the primary beneficiaries of this rotation in the month of September, as market participants looked to benefit from the spike in energy prices caused by supply shortages.

On the topic of supply shortages, persistent disruptions in the supply chains across a wide swathe of industries continue to cause issues. The reasons for these disruptions are numerous, but particularly harsh measures to stop the spread of COVID in several Asian economies have dramatically cut the output from what is essentially the manufacturing hub of the world. This 'lockdown & eliminate' strategy contrasts with the 're-open as safe' approach taken in Western Europe and North America (although admittedly developed economies have had greater access to vaccines to date.)

The ongoing disruption to supply chains will likely have several near-term impacts: an inability to meet Christmas consumer shopping needs seems like an obvious example. Moreover, given the limited manufacturing capacity and major disruptions to shipping, it seems as if input-price pressure will remain acute for the foreseeable future. In short, we do not expect the inflationary pressures to start receding just yet.

To be clear, our view of inflation since the end of 2020 has been that we will see it run hotter for a period of time than has been the case in the years leading up to the pandemic.

Our response to this remains unchanged: owning real assets (i.e., businesses) that have sufficient pricing power to benefit from a period of higher inflation. We believe this provides the surest store of value over the long term.

Outlook

In our prior communications with investors, we highlighted our expectation for a bumpier second half of the year (an example of which we witnessed during the last week of the quarter in particular). The Fed tapering its QE programme, tough negotiations on the US debt ceiling, a slowdown in China, supply chain disruptions and rising energy prices creating inflationary pressures all create near-term headwinds that markets must navigate.

While these concerns always tend to attract the most headlines, none of them individually appear insurmountable; collectively, however, they are manifesting as increased near-term volatility. Looking through the headlines, the underlying global economy continues to progress in the right direction, the US consumer remains strong and there are numerous signs that corporate America is investing in future growth.

Our investment strategy remains the same. We will own competitively advantaged businesses with prodigious amounts of cash on hand and cash being generated, run by competent and honest people. These are businesses with sound fundamentals and staying power; they will not disappear as a result of a market correction. If anything, we believe the competitive advantages of our businesses will be enable them to better navigate any short-term challenges that play out in the real economy.

When we believe we have both an edge in understanding as well as a margin of safety, we plan to prudently invest your capital, taking advantage of near-term market dislocations to entrust it to the right business managers at the right price.

Performance to 30 September 2021

	GHCF	**Benchmark**
Financial Year 2022	+3.2%	+3.9%
2021 (Calendar YTD)	+18.6%	+20.8%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+42.7%	+35.5%
Annualized Since Strategy Inception	+18.6%	+15.7%

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

The present bout of volatility may create opportunities to put money to work. We will communicate any progress on this front to you as and when we have made headway.

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 sincerely hope to meet with our investors in person over the remainder of 2021 as lockdown restrictions are relaxed. Until such time, please feel free to contact us directly if you have any questions.

Kind regards,

Etienne, Les, Dan and Andrew

Under the Microscope: Thermo Fisher Scientific

by Daniel Gerdis

Formed in 2006 through the merger of Thermo Electron and Fisher Scientific, the company is a world leader in providing analytical laboratory equipment and consumables used in the discovery, analysis, and manufacturing of pharmaceutical and other life sciences products. Over the past 18 months, Thermo Fisher Scientific (Thermo) has experienced a surge in demand for its suite of vaccine discovery, analysis and testing products to help combat the COVID-19 pandemic. While the market took the view that much of this demand was transitory, our analysis suggested that the pandemic had significantly expanded Thermo's opportunity set.

A Reputation for Reliability

Thermo's business operations possess a unique trait that we can best describe as offering a high 'value-to-cost' ratio to its customers. In short, this refers to providing a product that is highly valued by the customer (and enables them to perform their daily tasks accurately and effectively) while only constituting a relatively small component of the total cost of carrying out said tasks. This attribute is best illustrated by way of a brief example:

The potential cost to a laboratory technician of using faulty or malfunctioning equipment when formulating and testing new compounds to be used in any drug can be disastrous – both to the pharmaceutical company engaged in drug development as well as the ultimate patient who consumes the drug. Faulty lab equipment can not only lead to inaccurate measurements (which waste time and resources) but can create significant reputational risk and incur severe regulatory sanctions.

Thermo's reputation for developing and providing best-in-class, technologically advanced equipment that is both accurate and reliable confers a strong element of pricing power for the group. The lab technician in our example knows that with Thermo they are getting a far higher quality product for a moderately higher price that will ultimately lead to cost savings from higher operational uptime and measurement accuracy, while at the same time mitigating downside risk.

A One-Stop Shop

Providing thousands of business-critical products in markets around the world, Thermo operates across a broad spectrum of industries with numerous competitors in each. Over decades, Thermo has built up a subtle but important advantage in offering one of the broadest product baskets in the market. Having the ability to provide their clients with one invoice for all the equipment and consumables required to run their business allows researchers and scientists to spend more of their time in the laboratory and less time on ancillary matters such as procurement. As a result, customers tend to consolidate their spending with Thermo over time. Ultimately, the wide product range creates a scale advantage that allows Thermo to be more cost competitive across its customer base, while still having a clear ability to pass on inflationary cost increases in any one particular item to that customer.

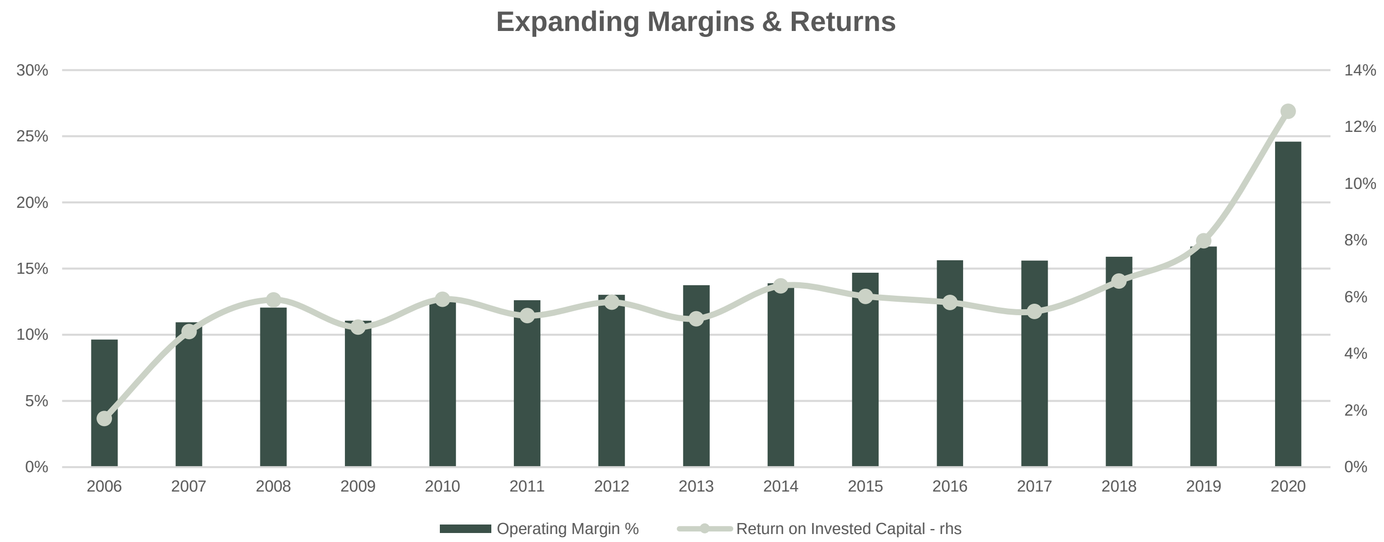
Creating Value for Shareholders

As a rule, we seek to invest in businesses that are highly cash generative; Thermo exhibits this core quality in spades. We then take our analysis a step further to identify businesses that are run by skilled management teams who can redeploy this capital into adjacent markets and products that deepen the competitive positioning of the business through time. Done repeatably, astute capital allocation enhances investor returns over long periods of time, and can even 'bootstrap' value-creating transactions in tough market conditions.

Thermo's management team have a strong track record of acquiring businesses selling products that are complementary to the existing product basket and highly valued by their customers. The scale advantage that Thermo brings to any acquisition means that unlike other acquirers, they do not need to buy a business growing at a faster rate than the broader group. Instead, Thermo has a proven ability to accelerate the revenue growth of an acquired business through an expanded sales and distribution reach, while at the same time growing the operating margins sustainably of the overall group. Simplistically, the growth rate of the acquired business is less relevant than the quality of the product at the time of being acquired.

Thermo's current management team have over 20 years of experience in focusing the group's capital investment on capturing the lower risk parts of the value chain. Two recent acquisitions leverage Thermo's scale advantage by acquiring both a clinical research organisation (PPD Inc. – a competitor to former Fund holding ICON Plc) to undertake clinical drug trials on behalf of customers, as well as a pharmaceutical contract manufacturer.

This vertical integration strategy means other participants will take on the regulatory risks of new drug approvals required to bring drugs to market, while Thermo partners with these companies to capture value from the clinical trial stage all the way through to packaging and labelling of the eventual product.

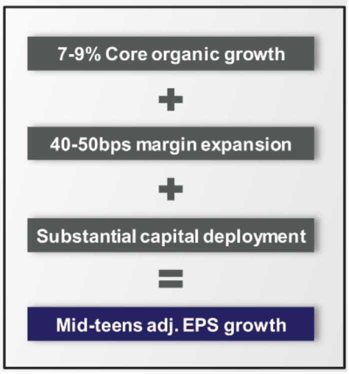


Source: Company data, FactSet

Sustainably Higher Levels of Demand

As mentioned previously, Thermo benefited from providing products that experienced a surge of demand in 2020 to help combat the COVID-19 pandemic. Following the announcement of effective vaccines in November 2020, the stock retreated as short-term traders viewed the revenue generated in response to COVID-19 as transitory and unlikely to recur. Ignoring the fact that we believe global biosecurity efforts will be permanently higher as a result of COVID-19 – leading to some level of sustained demand for testing products – our analysis suggested that the underlying technological innovation of the way in which viruses are studied and vaccines developed would drive a permanent change in demand for the products that Thermo sells. The rapid timeframe for the effective discovery, approval and manufacture of COVID-19 vaccines globally were years in the making, enabled by businesses such as Thermo.

Given our view on sustainably higher levels of demand – and our confidence in a management team that wisely allocates capital and consistently reinvests in expanding the capability and capacity of the group to service aforementioned demand – our investment thesis essentially took advantage of the market's short investment horizon ("now that we have vaccines, what should I own to benefit from the economic rebound?") to purchase part of a deep-moated business with a long runway of growth at what we considered to be a perfectly attractive price.



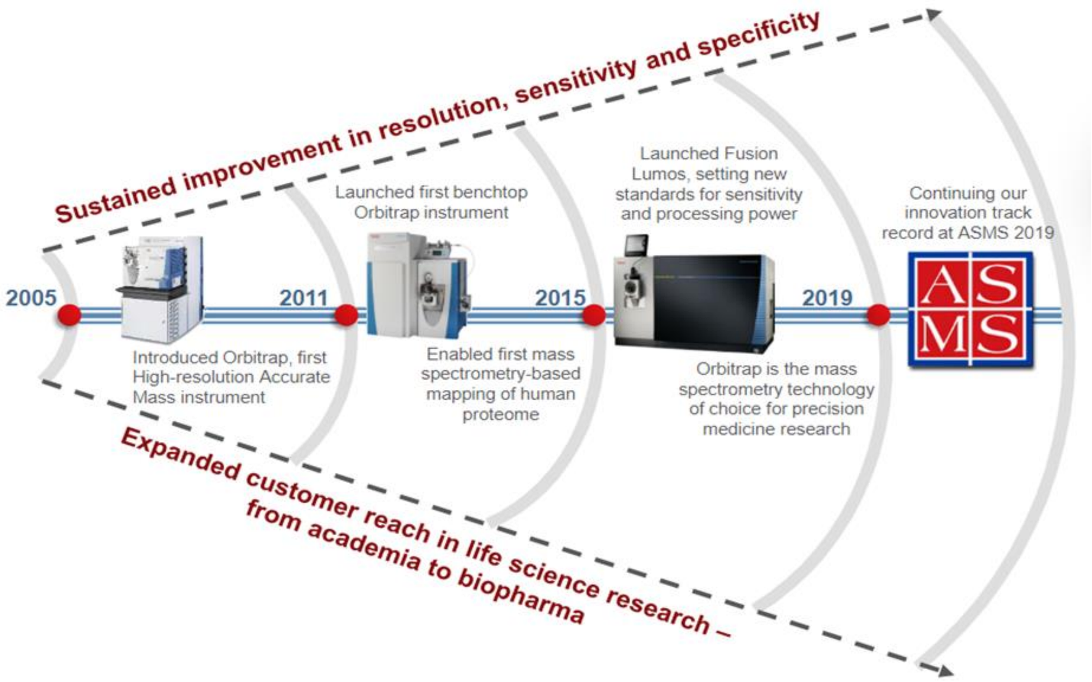
Source: Thermo Fisher Scientific Investor Day 2021

At their September 2021 investor day, Thermo Fisher's management confirmed that revenue growth from 2022 onwards would indeed be at a faster rate than what was experienced by the business prior to the 2020 pandemic, largely as a result of the factors we had outlined above. In addition, ongoing margin expansion and disciplined capital allocation – using twin levers of acquisitions and share repurchases – would see earnings and free cash flow compound at mid-teens rates of growth. Following the investor day, we have increased our allocation to Thermo as the risk/reward equation has developed favourably for our investment thesis.

Complexity Compounds the Long-Term Opportunity

The world around us gets more complex every day. To use a simple example: if one thinks about the groceries that we buy on a daily basis, the displayed nutritional information of the ingredients continuously becomes more numerous and detailed in nature as consumers become more educated and regulators stricter about disclosing the content of the food we consume.

As the world becomes more complex, the trend towards more data requiring more analysis will play out in numerous ways. What may appear to be a relatively pedestrian pace of advancement on a day-to-day basis can create enormous opportunities when taking a longer-term perspective. This fact allows us to take advantage of trends that may be of little to no relevance to short-term traders. Technological innovation allows for what historically may have been expensive, time-consuming analysis and diagnosis to become more affordable and more accurate in shorter time periods. By way of example, the Orbitrap mass spectrometer that Thermo manufacturers today is a much more powerful and advanced piece of equipment than when it was first introduced in 2005.



Source: Thermo Fisher Scientific

This never-ending technological advance broadens the use cases and customer base for Thermo, who continually reinvest in the research and development of new innovations that simplify the measurement of an increasingly complex world. If the truism that "if something is to be managed, it is to be measured" is accurate, then owning a business that sells the measurement equipment makes sense to us.

Thermo Fisher Scientific fits our criteria of being run by a management team that understands the benefits of combining market leading organic growth with prudent capital reinvestment at attractive rates of return. In combination, these two factors drive the long-term compounding of shareholder value.

Sic Parvis Magna: Great Things from Small Beginnings
by Etienne Vlok

One of our favourite pieces of wisdom from Charlie Munger is his so-called first rule of compounding: “never interrupt it unnecessarily.”

Would you get out of bed for a daily return of 0.073%? It does not sound like it is worth the effort, but a daily return of 0.073% over roughly 250 trading days in a year equates to an annual return of 20%. An annual return of 20% leads to some remarkable outcomes over time:

Year	0	5	10	15	20	25	30
Investment Value	100,000	248,832	619,174	1,540,702	3,833,760	9,539,622	23,737,631
Multiple on Original Investment (x)		2.5	6.2	15.4	38.3	95.4	237.4

While most people would agree turning $100,000 into $250,000 (2.5x the original investment) is a good outcome over five years, note the value in years 10 (6.2x the original investment), 20 (38.3x) and 30 (237.4x). The math is heavily back-end loaded – in fact, nearly 60% of the ultimate value of $23.7mn is generated after year 25.

Everyone seems to intuitively agree that compounding delivers wonderful results over time, but very few seem to take heed that one of the main ingredients to this kind of outcome is the patience to let the compounding effect take hold. Instead, the temptation to ‘do something’ overrides Munger’s first rule. The result is performance chasing – trying to own what is working right now.

Writing in *The Big Secret for the Small Investor*, Joel Greenblatt – himself a star in the firmament of successful long-term investing – relates the following story based on a Morningstar study covering the decade ended 31 December 2009:

> *The best performing stock mutual fund of the last decade earned more than 18 percent annually. […] This is particularly impressive since the market as measured by the S&P 500 was actually down close to 1 percent per year between 2000 and 2009.*
>
> *Yet, the average investor in this same fund managed to lose 11 percent per year over those ten years. How?*
>
> *Pretty much after every period the fund did well, investors piled in. After every period the fund did poorly, investors ran for the exits. The average investor managed to lose money in the best-performing fund purely by buying and selling at just the wrong times!*

This anecdote should give every investor a moment of pause. Turning a positive 18% compound return into an 11% per year dollar-weighted loss over a decade speaks to the fundamental contradiction at the heart of successful long-term investing: it requires contrarian action, the ability to weather volatility, and the wherewithal to stick with an investment strategy.

The problem, of course, is that our collective ingrained loss-aversion response wants every fibre of our being to put a stop to the psychological pain and anguish of short-term volatility and drawdowns by selling out. More often than not, such moments present good opportunities to allocate capital. (A helpful way to frame the conundrum: lower prices today equate to higher returns in future.)

Our Goal: Long-Term Compounding

Ultimately, our goal is to compound our clients’ wealth over long periods of time. By being rigorous as to the quality of businesses we own, we hope to reduce the fundamental risk of achieving this outcome. It also explains why we are so focused on the returns on capital generated by the businesses we own (as opposed to the rate of year-over-year growth). Munger again:

> *Over the long term, it is hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for forty years, you are not going to make much different than a six percent return – even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you will end up with one hell of a result.*

What is critical for our investors to understand is that we will not compromise our quality-focused process or philosophy to try and win the horse race of annual performance. Long-term compounding is much harder to achieve if one tries to do so in a series of 12-month sprints, where the goal is simply to be 'ahead of the game' over every individual measured period.

If this sounds like we are waving the white flag on performance, the truth is much the opposite. We do not expect our investors to ignore our results over the medium-to-long term; as an active manager, we want to outperform the market over time. To do so, we need to perform the bottom-up analysis and purchase high quality businesses at prices that include a margin of safety, and our commitment to our investors is to stick to our philosophy and process to deliver on these goals. Our point is simply that we are trying to compound your capital over the long term, not 'win' in every individual period. There is a graveyard of investment managers who have attempted to do the latter.

Consider the analogy of comparing long-term investing to the Tour de France – one of the ultimate tests of sustained performance – favoured by British investing legend Terry Smith.

The Tour consists of three types of stages: the flat or rolling stages, the mountain stages, and time trials.

In a time trial, cyclists are set off individually whilst wearing skin-tight clothing on an aerodynamically optimised bicycle. As this stage is a straight-up test of unassisted riding ability and power output, it is usually won by relatively larger riders with an ability to deliver a high power output for a sustained period of time. The time trial – being a competition against the clock – is sometimes referred to as the 'race of truth,' as it relies solely on the cyclist's ability to master the elements.

Conversely, the flat or rolling stages require a different strategy. The race generally sees the whole peloton riding a stage to the finish line as a group. Riders reduce the amount of effort required by slipstreaming in the peloton. In fact, each rider can save up to 30% of energy by cycling behind other riders who are going out front. (For comparison, think about what happens when you put your hand out the window of a car going 50km/h; reducing that kind of wind resistance is the point of riding in the peloton.) The designated sprinter for each team – who is hopefully still fresh from being able to slipstream in the peloton – is usually set loose close to the finish line in order to win a sprint victory.

The mountain stages are normally won by climbers, who tend to be much smaller and lighter cyclists that optimise their power-to-weight output to keep up their speed for longer as they work their way uphill. In these stages, it is all about endurance when fighting the forces of gravity.

The point is that sprinters have a very different body type than time trial specialists, and a cyclist who is a successful sprinter is unlikely to win a time trial (and vice versa.) Good climbers are generally smaller in stature, and generally do not excel at sprinting. In short, there is no single rider with the physical attributes required to excel in all three stages.

Interestingly enough, the Tour de France has been won on eight occasions by riders who have never won a single individual stage. In their case, the secret was to be excellent at one of the disciplines, and good enough at the others that they remained competitive throughout the entire Tour. The key to their long-term success was consistency.

The lesson from this analogy for investors is obvious. Many investors look for an investment strategy that can outperform in every conceivable set of market conditions; the historical evidence emphatically confirms that this is impossible. Trying to actively position to outperform month-by-month, quarter-by-quarter and even year-by-year is ultimately a fools' errand, likely to lead to the type of return profile discussed by Greenblatt as one attempts to pick the 'momentum' stock, sector or strategy that is working in the moment.

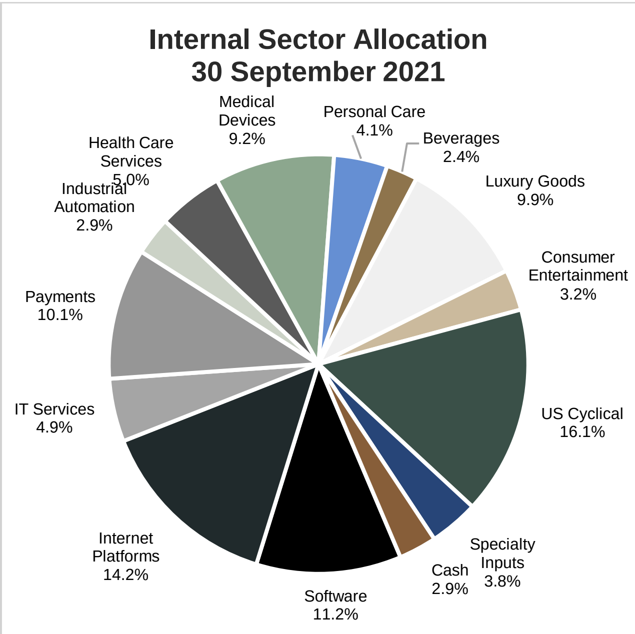
When it comes to successful long-term investing, it pays to try and win the Tour, not every individual stage. We think our quality-focused process will deliver this outcome over time. The consistent aggregation of incremental gains – in other words, compounding through time – will deliver the 'great things from small beginnings' that Sir Francis Drake had on his family coat of arms. *Sic parvis magna*, indeed.

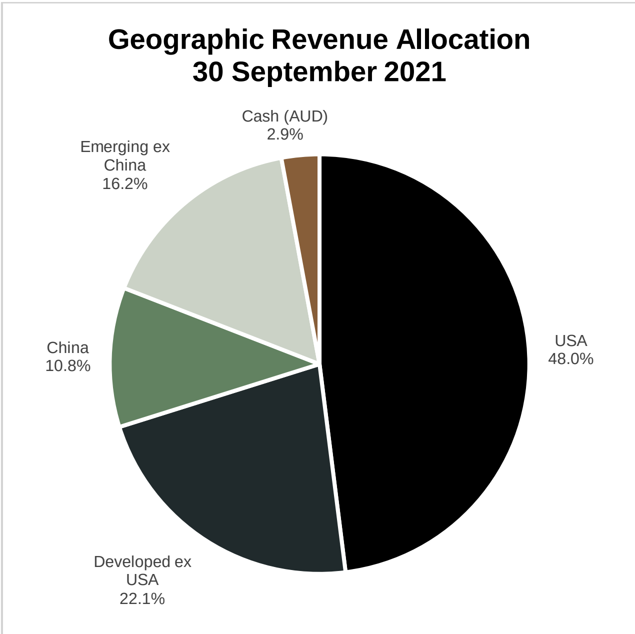
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Sept. 2021
Profitability			
Gross Margin	55.7%	49.8%	51.7%
Operating Margin	23.5%	20.1%	22.5%
Free Cash Flow Margin	18.9%	17.0%	17.7%
Returns on Capital			
Return on Assets (ROA)	13.0%	11.9%	12.0%
Return on Equity (ROE)	28.3%	24.9%	25.8%
Return on Invested Capital (ROIC)	24.0%	16.5%	17.6%
Leverage			
Debt/Equity	87.2%	68.6%	70.2%
Net Debt/Equity	19.3%	22.1%	21.8%
Valuation			
Free Cash Flow Yield	2.8%	3.2%	3.1%
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	23
Active Share	86.5%	87.8%	87.6%

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
HEICO	US Cyclical
LVMH Moët Hennessy • Louis Vuitton	Luxury Goods
Microsoft	Software
	Luxury Goods
PayPal	Payments
ThermoFisher Scientific	Medical Devices
UnitedHealth Group	Health Care Services