Constantia Investment Partners

Annual Letter
2021

Dear fellow investor

In 2021, the AIM Global High Conviction Fund delivered a return of +31.14% after all fees.

Considering the wall of worry markets had to climb in 2021, we are pleased to say that sticking to our process – owning high quality businesses for the long-run, and refusing to be bound by the false contradiction implied by the ‘value’ and ‘growth’ labels so readily ascribed by the market – has seen us through in reasonably good stead.

In particular, our efforts to ensure our businesses can exhibit pricing power in a period of rising input cost inflation was a key driver of the outcome we delivered. Higher inflation no longer seems to be as ‘transitory’ as hoped for by central banks, meaning businesses blessed with the combination of pricing power and a low requirement for reinvestment in tangible capital should still be positioned well, regardless of what happens next.

We intend to stay true to our philosophy: own high-quality businesses that can compound into the future, and use periods of market dislocation as opportunities to acquire or increase our ownership of such businesses with a greater margin of safety, with a view towards long-term business ownership.

Performance to 31 December 2021

	GHCF	Benchmark
Financial Year 2022	+14.1%	+11.3%
2021	+31.1%	+29.3%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+57.7%	+45.1%
Annualized Since Strategy Inception	+21.5%	+17.3%

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.)

Our Annual Letter

As an investment team, we remain committed to providing our investors with a high level of transparency into the businesses the Fund owns on your behalf. Our Interim and Annual Letters are crucial tools in achieving this goal, with the Annual Letter being the most detailed of our communications to you in any twelve-month period.

This Annual Letter is divided into four 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.
- In Part Two, we examine a few lessons learned and insights gained in 2021.

- Part Three discussed the repeatability of our investment process in compounding your wealth.
- Lastly, in Part Four, we provide some concluding thoughts on where we see risk for markets in 2022.

Conclusion

As we close the book on yet another decidedly less-than-ordinary year in global markets, we would like to take this opportunity to thank all investors – new and long-standing – for your ongoing support. Our goal remains the long-term compounding of your wealth through sensible capital allocation.

At the back of this letter, there is the usual addendum containing our quality scorecard, internal sector allocation, geographic revenue exposure, and the top ten holdings.

Please get in touch if you wish to discuss any aspect of the Fund.

Kind regards,

Etienne, Les, Dan & Andrew

Part One: CY21 in Review

by Etienne Vlok

For the calendar year ended 2021, the AIM Global High Conviction Fund (GHCF) delivered a return of +31.14% after all fees. This compares to a benchmark return of +29.29%.

A 30%-plus year is hopefully a 'good enough' outcome in anyone's book but outperforming the benchmark by 1.8% (after fees) hardly feels like something to get excited about. Normally, we would agree. However, 2021 was anything but a 'normal' year, and when considering the factors that drove markets at various points over the past twelve months, we are pleased with the outcome as an investment team, while remaining conscious that (as always) there is more work to be done.

The proverbial 'main event' that markets had to navigate in 2021 was the ongoing economic recovery as progress was made with vaccine rollouts around the world. Progress on this front had to be weighed against higher levels of realized inflation that stemmed from excess consumer demand, disrupted supply chains, and a very tight labour market, all of which resulted to some extent from the extreme measures taken in 2020 to support the global economy through the worst of the pandemic. We had flagged the risk of higher inflation extensively during the latter months of 2020, and already positioned the Fund for a variety of possible outcomes prior to entering 2021.

The generally recommended 'trade' at the start of 2021 was to go overweight the value factor (or at least, businesses with lower starting valuations) relative to 'growth' stocks. Many of these traditionally labelled 'value' stocks were concentrated in business sectors (financials, energy and materials) we mostly consider outside the bounds of our investable universe, largely because the underlying businesses do not sustainably generate returns on capital that meet our minimum hurdle rates.

Indeed, at the end of 2021, the only three sectors that managed to outperform the broader market index (+29.3%) were energy (+48.7%), financials (+35.7%) and real estate (+36.6%). Generally speaking, you'd have done quite well by owning these more 'value'-tilted sectors in 2021 and going to the beach. (If only someone were kind enough to publish this data in advance of the year commencing rather than at the end, we certainly wouldn't fault you for doing so; however, since we lack the clairvoyance required to follow this strategy, we'll stick to our knitting!)

The Fund had no exposure at all to the best performing sector (Energy), and very differentiated exposures in Financials (Berkshire Hathaway is most certainly not a bank) and Materials (Croda PLC is a provider of speciality chemicals, i.e., not a producer of commoditised metals.)

Thus, the fact that the Fund modestly outperformed the market came down to our stock selection. The result gives us confidence that our research and portfolio construction processes are working as intended, and hence the reason why we are at ease with the relative return of +1.8% we have delivered for our investors. We might be pressed into at least admitting we are 'happy' about the absolute return, but no champagne corks are popping; we have a tricky market to navigate in 2022.

The investment team has been around long enough to understand that in the short-term, the **flow of liquidity** sets prices, and **sentiment drives flows**. If sentiment is favouring a particular sector, stock or investment factor/style at the cost of another, flows into these beneficiaries lead to more buyers than sellers, pushing prices higher as demand exceeds supply. There is no doubt that in 2021, the perceived safety and quality of our businesses attracted buyers. This could obviously work in the reverse. (In fact, as we put pen to paper for this letter in early January 2022, this seems to be exactly what is happening: our "quality" businesses are being sold to fund the purchase of "value" names).

Trying to predict sentiment (a Keynesian Beauty Contest) and benefit from short-term flows is outside of our circle of competence. We want to own businesses for the long run, not trade their stock in the short-term. This leads to a point worth highlighting: the longer one intends to own a business, the greater importance one should place on its competitive position, industry dynamics, management ability and capital allocation track record. To quote from our June 2021 Interim Letter:

> *[…] it is worth pointing out that over as short an investment horizon as one year, the vagaries of what is currently in vogue ("Value! Growth! Reflation! Deflation!") is largely driven by narrative and sentiment. We believe that fundamentals win out over the longer term, meaning that as time goes by, the performance we aim to deliver to you will increasingly be attributable to the hard work of the management teams and staff employed by the businesses we own on your behalf. Our job is to prudently allocate your hard-earned capital to trustworthy people at an attractive price, and then to let them get on with creating value.*

We do not invest your capital with an annual investment horizon in mind; we plan to be perpetual owners. As Warren Buffett has pointed out, "our investments simply are not aware that it takes 365 days for the earth to make it around the sun."

We would caution investors against mentally extrapolating the rate of return we have delivered this year; there will undoubtedly be leaner periods at some point in the future. The right way to think (and survive) in markets is to have a stoic disinterest in short-term results (which a single calendar year would be, in our opinion) and rather focus on our longer-term compounding ability. Since the shift to the long only strategy (August 2019), the Fund has returned +57.7% (+21.5% annualised) net of all fees, which is an outcome we are pleased with when compared to our long-term return target of 8% - 12% per year.

Our Return Profile

For the sake of clarity, we absolutely believe there will be periods where our strategy will underperform the market. (From experience, this happens about one in every three or four years).

We believe our quality-based 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 markets then favour lower-quality, cyclically sensitive stocks. As the business cycle matures, we expect our businesses to outperform due to their intrinsic competitive advantages and superior capital allocators at the helm, leading to their internal pool of capital compounding at a high rate of return.

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 day, week, month or quarter, and we certainly do not position the Fund to try and do so.

It is not uncommon in our industry to find that bonuses are paid on the basis of annual outperformance, meaning it should come as no surprise that there is an immense focus on trying to outperform the benchmark in 12-month increments. We think this goal (outperforming every year, requiring a huge amount of portfolio turnover to capture 'what is working right now') is very different from what we are trying to achieve: to compound our investors' capital in a low-risk manner over time.

In our experience, the excess returns (also referred to as 'alpha') of a quality strategy is usually earned unevenly over time, which is why we believe that time in the markets – owning business that can compound their internal capital and thus intrinsic value – allows the patient investor to capture this alpha by staying the course through these cycles. If we are right about the long-term prospects of our businesses, we believe we'll do just fine alongside our investors, with no need to swing for the fences in any one particular year to 'make the numbers.'

What Did Not Work in 2021? Chasing the 'New' at any Price

2021 was a year in which there were a lot of narratives spun about the 'new' displacing the 'old' in our economies. To be sure, Schumpeter's "gale of creative destruction" is blowing at full force today, and we are not blind to the risk of technological disruption across many industries we cover and businesses we own. However, investing in the 'new' is at the best of times a risky endeavour.

The problem in trying to predict the future with any degree of precision is that it is inherently unknowable. Speculating about how the world will change in ten years' time is a fun mental exercise, but to make money from said speculation, a phenomenal number of things have to go right: not only do we need to guess 1) the correct variables (i.e. the things that will change), but then 2) correctly estimate how the variables will change, as well as 3) how the market will react to these changes relative to the previously embedded expectations for the status quo.

Frustratingly, one can be right about the general trajectory of technological advancement (the car replacing the horse-drawn buggy, for example), but still lose money hand over fist by trying to invest in the change (cf. investing in automakers for the majority of the 20th century.)

Lastly, if there is an obvious prospect to execute a land-grab in a rapidly evolving market due to technological development creating new opportunities, there is a clear economic incentive for capital to flood into this industry to fund a vast array of new entrants, all of which will try to claim the #1 position. This is a classic capital cycle, and in our opinion, not the kind of investment opportunity which reliably leads to long-term wealth creation. As a rule, we prefer to avoid any industry into which new capital is entering rapidly, as the resulting rise in competition likely means poor returns on capital until there is an industry shakeout, with weaker players exiting and allowing stronger players to consolidate the market.

We think a better question to ask is "what will stay the same for the next ten years?" We believe we can find much better opportunities in businesses that have embedded in their value proposition a natural resilience to technological disruption. For example, we are reasonably certain that people will still want to exercise, stay healthy and be fit ten years from now, meaning Nike's core product is unlikely to be disrupted. Simplistically, the technology requirements of large enterprises will continue to become more complex, meaning there will always be a role for a technology-agnostic partner such as Accenture to advise their biggest clients on the best path forward.

To quote the narrator in Robert Pirsig's *Zen and the Art of Motorcycle Maintenance*:

> *"What's new?" is an interesting and broadening eternal question, but one which, if pursued exclusively, results only in an endless parade of trivia and fashion, the silt of tomorrow. I would like, instead, to be concerned with the question "What is best?," a question which cuts deeply rather than broadly […].*

We agree. Looking exclusively for 'what is new?' means you'll end up wasting a lot of effort on businesses that have novelty but ultimately no staying power. The 4th quarter of 2021 is littered with cases of 'pandemic winners' falling off a cliff because investors over-extrapolated the trends of the pandemic into a 'new normal.' Some of these businesses may recover, but we wouldn't be surprised if many do not.

We look for businesses that are to a large extent protected from fundamental technological disruption, yet still flexible enough to change to meet the developing needs of their customers. 'What is best?' leads to questions around management integrity, capital allocation track record, moat (widening or being eroded?) and culture – all of which are vital to our interests as equity owners if we intend to be long-term owners of a business. These businesses are rare, and to find them trading at a material discount is even rarer. However, they tend to have very long runways to compound in value, and given enough patience on our behalf, will be more than enough to generate the long-term returns we seek to deliver.

Thus, in a year where retail investors engineered a short squeeze on Gamestop, where NFTs took off in a big way, and where every conceivable cryptocurrency was promoted to go to the moon, we feel rather happy to say: "not our game." Beyond that, we'll stick to owning quality businesses that can compound, hopefully for a very long time. Implied in this statement is a healthy degree of paranoia regarding our businesses being disrupted, which tends to bring a rather sudden stop to the compounding process. We are not blind to the 'new'; we just don't see the need to thoughtlessly chase novelty for the sake of it when trying to deliver compound returns to our investors over time.

Part Two: Lessons Learnt in 2021

by Andrew Strasser

For us as an investment team, the largest lesson of the year no doubt was to maintain a balanced portfolio that was not just positioned any one way, but instead positioned to hold up under most market conditions.

As we've already noted thus far in this Annual Report, market sentiment shifted multiple times in 2021. We saw some egregious bubble-like behaviour from retail investors in meme stocks, zealot-like praising of ultra-long-duration stocks promoting new technologies (e.g., variations of the 'Buy Now Pay Later' formula and cryptocurrencies) and material swings towards commodity producers and traditional 'value' names as fears of sustained inflation gripped the market. As tempting as it may have been to try and chase all these market trends for outsized returns on a quarter-by-quarter basis, the market gyrations in 2021 were also very punishing if you didn't time your entry and exit on these trades perfectly. Many 'growth' companies in the technology sector who saw their stock prices heavily supported in the early parts of the year, found that by the fourth quarter their prices had fallen as far as fifty percent from their highs.

Thankfully, we do not play this game, because to be frank we don't think it fits in with our pathway to compounding your wealth. Instead, throughout 2021 we endeavoured to maintain a balanced portfolio of diverse companies, even finding ourselves increasing the balance as the year progressed and the variance in potential outcomes (notably, due to inflation) widened.

We finished the year with our top 5 holdings including Berkshire Hathaway (US Cyclical), HEICO Corp. (US Cyclical), Thermo Fisher Scientific Inc. (Medical Devices), Accenture PLC (IT Services) and Constellation Software Inc. (Software): hardly a list representing a one-way bet.

The second major lesson of 2021 was to largely ignore these swings in market sentiment and remain focused on company fundamentals but use the changes in market valuations to one's advantage.

As equity research analysts, we spend most of our time and effort developing a long-term picture of what we believe our companies' business and financial destination will look like in 5 years' time (noting that we're not clairvoyant and all estimates carry forecast risk; hence our use of scenario analysis). However, when determining weightings in the portfolio we can use short-term gyrations in market multiples to help us manage risk by adjusting positions as the risk-reward profile changed.

Let's use Alphabet as an example.

At the end of 2020 the company's stock price was around US$1,750, which was well below our assessment of intrinsic value at the time, largely due to the market's focus on regulatory concerns. Whilst we noted that the regulatory environment had been heating up for data collection and push-mechanism-based advertising amongst mega-cap tech companies, we thought the downside risk to Alphabet's core business, search advertising, was overblown. Additionally, we had strong conviction that online advertising volumes (particularly search advertising) would not only rebound in 2021, but that they would continue to grow at an accelerated rate thereafter as eCommerce usage accelerated and advertisers shifted marketing spend away from linear media formats towards online advertising. In other words, we ignored the market narrative and focused on the company's fundamentals: growth would re-accelerate and continue, and margins would rebound and remain steady. Helpfully, this rebound played out, and the market became more optimistic on the future of online advertising, particularly search advertising. Alphabet remained a top 3 holding for most of the year.

However, by September 2021 the company's stock was trading closer to US$2,850 and the gap to our estimate of intrinsic value had narrowed. Whilst we still firmly believe in the company's long-term opportunity set, dominant competitive advantages and management's ability to allocate capital appropriately, we reduced the weighting in the portfolio, as the risk-reward profile had changed. The regulatory concerns and left-tail risks that existed at the end of the prior year were (and still are) very real, but the margin of safety being offered at the market price in the latter part of the year was significantly lower.

This is one of the benefits of being investors with a ‘business ownership mindset’ in publicly listed equities: even if we still believe in the long-term fundamentals, we have the ability to reduce our exposure when the risk-reward profile of a position meaningfully changes. To be clear, we don’t intend to exit the position unless the fundamentals (which includes the possible impact of regulatory changes) deteriorate, but we will continue to use short-term changes in the market valuation to our advantage where possible.

Part Three: Winning the Season, not the Game

by Daniel Gerdis

There are many components – both quantitative and qualitative – that go into a successful investment strategy. Among these are the stability, experience and focus of the investment team managing the fund; having an objective risk management process for understanding, acknowledging and controlling for human biases is another. Two key attributes would certainly be clarity of investment philosophy (i.e. continually asking oneself 'what kind of businesses are we looking to invest in?') and the repeatability of the investment process. Each of these individually play key roles in both generating investment returns and importantly, managing the risks that are taken in generating those returns. In this section we discuss what binds these elements together for repeatable decision-making success.

Knowing Where You Are on The Field of Play

The equity market is a living creature, one that is constantly evolving and adapting. Therefore, understanding where you are in the cycle of the market at any given time is equally as important as understanding how far into the season you are in sporting terms (or alternatively for short-term focused investors, how far into a particular game you are). An effective sports coach will have a good understanding of how many games have been played in that season, as well as what has worked particularly well and what has not. Each game presents new information that – if incorporated – ideally contributes to future success and avoiding the repetition of tactical errors. Successful coaches and managers understand when it is time to play offensively vs. defensively, and know that the skills and qualities that make a team successful today are not necessarily the ones that will lead to future success in seasons to come.

Any coach worth their salt will constantly reassess their decisions made by asking themselves "do I have the right mix of players in any one game, and at any given point in time, based on the outcome I am trying to achieve"?

These concepts apply similarly to the world of investing. A successful decision-making process is one that is constantly reviewed, with decisions interrogated post-mortem to enhance the process going forward.

Having the Right Team

One can think about a portfolio of companies in the same way as a team of players. Repeatable success means having the right balance of companies within the portfolio, not filling a portfolio with offensive goal shooters and leaving oneself exposed with no defensive qualities for downside protection. Understanding what you are playing for will determine what decisions are made in the composition of the portfolio.

Our goal is to compound your wealth through cycles. This means we do not bet the farm on any one company in the fund (akin in sporting terms to betting on any single player in the team) or aim to outperform every single day/month/quarter (again, in sporting terms, aiming to win every single game by the widest possible margin). Instead, we ensure the portfolio possesses a range of businesses (across geographies and industries), each with uncorrelated characteristics that play an important role in generating long-term sustainable returns through each cycle.

Having a Winning Framework

Through our time in markets, we have found that having flexibility built into our investment process allows for an adaptive way of thinking. The strategy that works in generating returns today could be one focused on deep value, earnings revisions, reversion to the mean, hyper-growth, or any one of numerous other concentrated approaches that are widely available to you as the investor. Tomorrow's winners are certainly not all to be found by looking at what has worked in the past.

Our framework marries a flexible approach in portfolio construction with rigorous and studious bottom-up stock picking. We have found this to be the best strategy to weather the risks and opportunities that lie ahead through various cycles. We believe the flexibility that has been purposefully built into not having to rely on or concentrate into any one investment style, sector, or theme, is of great advantage to our investors.

Game Changer

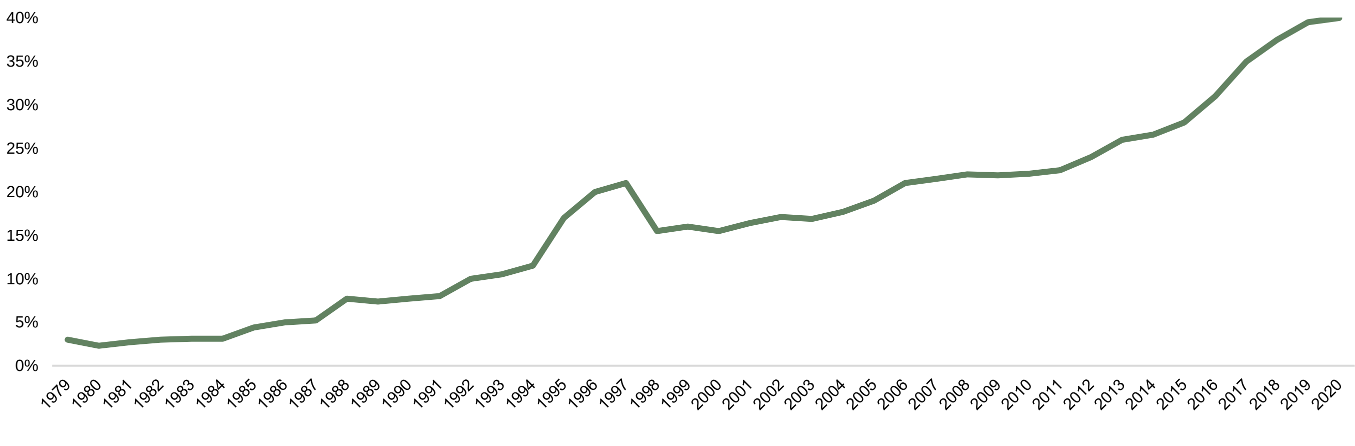
In their research paper entitled *Turn and Face the Strange* (Counterpoint Global Insights, 2021), authors Michael Mauboussin and Dan Callahan draw parallels between professional sports teams striving to win games and investment managers who similarly aim to earn excess returns. Their work (which we have referenced in our writings to you on a number of prior occasions) details how in the 1979 basketball season in the United States, the NBA introduced a line on the court behind which a player had the opportunity to score 3 points for making the shot rather than the usual 2 points closer to the net. This has subsequently become familiar to basketball lovers worldwide as the '3-point line'. The idea behind this innovation was to reduce player congestion around the net and make the game more exciting for you, the viewer.

As the 3-point line was an innovation, at the time of its introduction there were few if any specialist 'long range' shot-makers playing in the NBA to take immediate advantage of this rule change. Mauboussin confirms this statistically in that fewer than 3% of all goal attempts in the five seasons post this introduction were from the 3-point line. When the facts changed in this case, it collectively took the coaches, managers and players the better part of 5 seasons to adapt their strategies to this rule change. Why did it take so long, one may ask? Heuristics and human cognitive biases almost certainly would have played a part. Coaches may have been slow to adapt their decision-making, anchoring instead around their tried and tested strategies of old. Similarly, team managers may have suffered from the common mental bias of loss aversion in their decision making, unwilling to risk a period of underperformance (and its related financial impact on the franchise) as new tactics and players are introduced to adapt to the new rules.

While the math is straightforward (the expected 'return' of a successful 3-pointer shot is literally 50% higher than that of a closer 2-pointer) the skill set required and the strategy needed to effectively take advantage of this rule change were very different. Clearly, there are numerous factors that go into the relative advantage of choosing to shoot for a 3-pointer over a 2-pointer (relative skill sets of the attacking and defensive teams are but one consideration) but suffice it to say that when the 3-point rule was introduced, there existed an arbitrage opportunity for a period of time post its introduction.

Recognising that the rules have changed yet anchoring to the status quo in order to preserve short-term wins can be a recipe for disaster in the long-term. To paraphrase the legendary Benjamin Graham quote, in investing (as in sport) there are times when a decision may in the short run be perceived to be detrimental to performance as the market acts as more of a voting machine. In other words, making the popular decision is perceptibly the right decision in the short-term. (Who doesn't want to see their team win every game they play?) But in the long run, when the market acts as a weighing machine, the popular decision can materially handicap performance. Returning to the NBA and fast forwarding to today, close on 40% of goal attempts are now 3-pointers. Those that anchored to the status quo at the time of the rule change by not embracing the 3-point line, would have been left for dead.

Percent Of Field Goal Attempts That Were 3-Pointers



Source: Turn and Face the Strange (Counterpoint Global Insights, 2021), Michael Mauboussin & Dan Callahan

How we generate returns for you as an investor is as important as the quantum of the return, as it scores the risk we are taking. Knowing what outcome you are playing for means that you do not need to take unnecessary or excessive risk to achieve it. We are playing for multiple tournaments and multiple seasons, not individual games. In this context, we make very different decisions regarding risk and volatility than going all in on any one game. We believe this is a key element of repeatable, successful investing.

In investing terms, what has worked historically is not necessarily what will continue to work into the future. By having a process and philosophy with inherent flexibility built in, we adapt to changes in the market. This means continually finding the right companies (akin to players that are skilled at 3-pointers) that will compound returns when the environment around them changes.

Where we differ perhaps from the sporting analogy is that as a spectator, one may be drawn to teams that excel at 2-pointers as they are more entertaining to watch. Our investment approach focuses on less visual excitement and more on the consistent delivery of 3-pointers. While the composition of our fund may look boring and unsexy at times, it is for good reason. We are planning to win the season, not to entertain the crowd in any one game.

Part Four: Outlook

by Etienne Vlok

One thing we learnt from 2020 was that making big macro-economic or market predictions can be extremely costly if wrong. (We were not, and still aren't, epidemiologists.) Instead of optimising for one specific scenario, we try to ensure the Fund could weather a range of possible outcomes by following a "prepare, don't predict" approach. So: expect no big pronouncements here!

However, we would be remiss if we didn't flag an issue that we think could potentially pose a risk at *some* point. (Conversely, it may never eventuate; "risk means more things can happen than will happen", after all.)

Excess Leverage Meets Rising Rates

It doesn't take much searching to find signs that there is a lot of "non-fundamental" (to put it euphemistically) activity in capital markets these days. Meme-stocks, NFTs, promotors who seem to unwittingly be describing an actual Ponzi scheme when explaining how the price of new cryptocurrencies of dubious nature will go up as more people buy into it… there's a lot to suggest that in the rush to participate in the "everything-rally" of the last 18 months, a lot of common sense has gone out the window in the name of not missing out. To quote US venture capitalist Josh Wolfe of Lux Ventures: "excess is in excess."

Most people will likely blame this behaviour on the low interest rate regime we currently find ourselves in. If capital is virtually free, then taking on debt to buy the proverbial lottery ticket is not the worst idea in the world, mathematically speaking.

As it relates to our job of investing in public equity markets, low rates have resulted in increasing amounts of leverage being employed by many participants to increase their exposure to certain types of equities, such as unprofitable but assumed hyper-growth businesses.

Oddities In Market Structure

As more and more capital has shifted to passive indexing over the last several years, it means prices are increasingly set by price-agnostic index ETFs (often of market-moving size) that are seeing inflows (or indeed, outflows.) Combined with the increased popularity of algorithmic or quantitative strategies targeting specific statistical style factors (value, growth, cap size, etc.), it should then come as no surprise that people buying businesses (and not trading their securities) make up an increasingly smaller percentage of trading volumes. In fact, a fascinating statistic that was recently shared with the investment team is that less than 10% of daily trading volumes in the US still relates to active, fundamental investing (i.e. buying a stock with the intent of long term ownership based on some assessment of intrinsic value.)

The implication of all the above is that the vast bulk of daily volumes now relate to systematic/quantitative or passive investing strategies. In our opinion, this change matters quite a lot, and is very likely partly behind the ever-decreasing average holding period of stocks in the US (now estimated to be as short as somewhere between six and eight months).

A Potentially Fragile Market

We think the *combination* of high levels of leverage and non-fundamental trading volumes creates a risk that markets could be particularly fragile, and vulnerable to any tightening of financial conditions. To paint one potential scenario:

- Imagine that interest rates rise sharply. As the cost of capital suddenly goes up, the math on being leveraged long a lottery ticket of dubious value may not be as attractive, and the resulting unwind as positions are taken off could be fierce.

- Such a de-grossing event (to use the industry term) inevitably leads to a spike in volatility, which then leads to risk models at quantitative fund managers to start flashing red, prompting risk officers around the world to tap their portfolio managers on the shoulder and telling them to take exposure off the table.
- Selling begets selling. Before you know it, major indices are down sharply. Large index ETFs start to experience outflows as passive investors head for the hills, leading to more price-agnostic selling.
- Amid all of the above, algorithmic strategies trying to navigate the carnage find that the statistical signals normally guiding their trading activities no longer reliably function. Eventually, the flow of money leaving markets overwhelm any rational price-setting function, causing prices to overshoot to the downside.

Effectively, we have described a market crash… and in case you thought we were purely engaging in conjecture, the above is an over-simplified summary of how the February/March 2020 crash played out until central banks stepped in to provide liquidity.

To be clear, we have <u>absolutely no idea</u> of when such an event might happen. We certainly expect financial conditions to tighten over the course of 2022 as central banks increase rates and look to taper their quantitative easing programmes, so there is every risk that something like the above could happen. We cannot ignore the possibility; to quote Josh Wolfe yet again, “failure comes from a failure to imagine failure.”

Of course, such volatility can also provide opportunity. As we wrote in Part One of this letter, we see our job being “to prudently allocate your hard-earned capital to trustworthy people at an <u>attractive price</u>, and then to let them get on with creating value.”

It will be important to discern if such a crash is due to the scenario painted above (i.e. a liquidity-driven crash) or whether something fundamental has worsened in the long-term outlook for the businesses we look to purchase. We’ll do our best to communicate our thinking on this matter to you as the year progresses, but if a liquidity-driven crash is the cause of more attractive opportunities, we will gladly take advantage of it.

A Final Word on Indices and Benchmarks

As mentioned earlier in this document, we think we delivered an acceptable absolute return in 2021, though our benchmark-relative return was more modest. This did prompt a discussion amongst the investment team: what is an acceptable benchmark in 2021?

Certainly, it’s easy enough to find a broad equity index to measure us against; in fact, the MSCI World does exactly that. You might also choose to compare our returns to the S&P 500, the Nasdaq, the Dow Jones, the ASX 200, the FTSE 100, the Nikkei, the Hang Seng, etc. etc. You get the point.

In reality, an index is nothing more than a possible opportunity set, but it is one of many; it is certainly not the ‘best’ opportunity set by default. We find that a surprising amount of people use an index as a ‘risk-free’ starting point from which to reason out their investment decisions, or indeed, to which they can compare their investment returns. Equity indices are many things, but risk-free they are not. (Cheaply accessible, in many cases, but not risk-free.)

We would argue that if one were to study the composition of many widely used indices as at the end of 2021, there is a lot of concentration risk in particular industries or businesses. (A lived, real-world experience: a few years ago, the largest constituent of the Johannesburg Stock Exchange All Share Index amounted to ~23% of the index weight; the business in question was Naspers, the South African holding company that owned a meaningful chunk of Tencent. Is that a ‘good’ index to measure returns against, or would it be too lopsided and risky? Said more plainly, would one comfortably own 23% of the portfolio in one stock?)

In addition, the average index contains a lot of businesses we wouldn’t consider investable due to their track record of earning returns on capital that do not exceed the cost of capital.

It is an interesting problem to consider, particularly in markets where fundamental investing makes up so little of the trading volume. Putting aside for a second that we manage client capital in a competitive market, it could be argued that the ‘true’ benchmark for most individuals is simply inflation-plus, since that’s the bogey which – if you can’t beat it over the long term – would cause your quality of living to deteriorate.

We will consider this issue in more detail in the coming months. We run a high active share (~89% at December 2021) relative to the index we benchmark against, but there may come a time when that active share may need to push even higher if we find opportunities elsewhere. That may lead to results that are different – possibly meaningfully so – from the benchmark. But if benchmarks become increasingly skewed, we’d prefer to keep on doing the right thing by investors – seek value that compounds – rather than be beholden to an index as benchmark merely because ‘it is there.’

In Closing

We are focused on one objective: compounding your wealth through cycles by maintaining a balanced portfolio of businesses that do not rely on any single macroeconomic outcome, nor the performance of any individual company, investment style, sector or geographical territory. As we have communicated with you in the past, we have positioned the fund to navigate multiple risks, both fathomable and unforeseeable. When it comes to long-term investing, survival matters.

In a handful of prior cycles, a key risk to wealth creation was the threat that inflation posed to the purchasing power of investors' hard-earned capital. Following the Global Financial Crisis of 2008/9 (and in part due to the response by central banks globally), the enormous amount of wealth created has reduced this risk in investor's minds for the better part of the last decade. While the current environment remains firmly 'risk-on' (given how freely available and inexpensive access to capital is for both investors and corporates alike) the ramp-up in both actual inflation and inflation expectations reinforces how important inflation beating returns are for long term wealth preservation.

In a world of low interest rates (albeit beginning to rise across numerous developed markets), we continue to prefer equities as the asset class of choice for inflation-beating returns. Our approach remains one of owning uniquely positioned businesses with considerable pricing power. We believe that in a potential inflationary scenario going forward, our businesses are best placed to preserve your wealth in real terms.

As we have highlighted, the Fund owns a handful of businesses that we expect will be long-term beneficiaries of wage inflation playing out in the US at present. Microsoft, Accenture and Keyence are three of these, as they sell – in a very literal sense - productivity. In a world where demand for goods is fundamentally strong and is driving the inflationary wage increases we read about daily, businesses that do not have the inherent ability to raise prices to offset cost increases are faced with a choice of either cutting expenses or increasing productivity to prosper. We believe demand for technology-enabled productivity solutions is a multiyear driver that all three of these companies are well-placed to capitalise on.

As a number of businesses learnt during the pandemic-induced recession of 2020, liquidity and access to funding can be capricious: plentiful when you do not need it, and exceedingly scarce when you do. Rising interest rates, a reduction in the relative growth rate, or even the withdrawal of monetary stimulus that much of the world has become accustomed to in recent years will be a significant headwind for overly indebted companies as well as poorly equipped governments and central banks. Our geographical exposure in the fund takes cognisance of the risk that not all country's balance sheets will withstand this withdrawal of global liquidity to the same degree. We expect there will be both relative winners and losers. Your investment team have lived and gained investment experience in numerous countries over multiple cycles, both in emerging markets and developed markets. We believe this withdrawal of liquidity is a time for caution in knowing not only *what* your money is invested in, but *where* your money is being invested.

Most would agree that 2021 saw strong asset price appreciation across numerous asset classes, in particular global equities. Consequently, the starting valuations in 2022 are elevated. As a result, we believe investors should expect more modest equity returns over the next year or two, given the elevated starting base: multiple expansion cannot continue forever.

At a bottom-up fundamental level, we continue to uncover excellent quality companies that, at the right price, should generate more-than-acceptable returns for investors through time. As a reminder, volatility in asset prices provides us with the opportunity to invest in these companies at more attractive starting valuations. We can promise you a disciplined and prudent approach to allocating your capital in the year ahead, just as we believe we have delivered on over the past two-and-a-half years. What our investors can bring to the table is the patience to stay the course to allow your wealth to compound as opportunities present themselves.

The US consumer remains the most critical driver of growth in the world's single largest consumption market; by logical extension, the US consumer forms to a large degree the engine of global growth. As US consumers' propensity to buy anything from TVs to Teslas has been boosted in recent years by declining interest rates and a strengthening housing market, many have been in the fortunate position to refinance their mortgages at lower rates, access home equity, and then do what they do best: spend! We recognize that there may come a time when higher interest rates and slowing home equity appreciation impact negatively on the confidence of the US consumer, which will impact economies around the world. As risk managers, we remain alive to this and many other hazards.

As we see the opportunities presented to us globally, we plan to remain nimble enough to take advantage of them on your behalf. This is why we continue to have only one, global high conviction fund that is made up of our best investment ideas, and communicate clearly how we invest your capital.

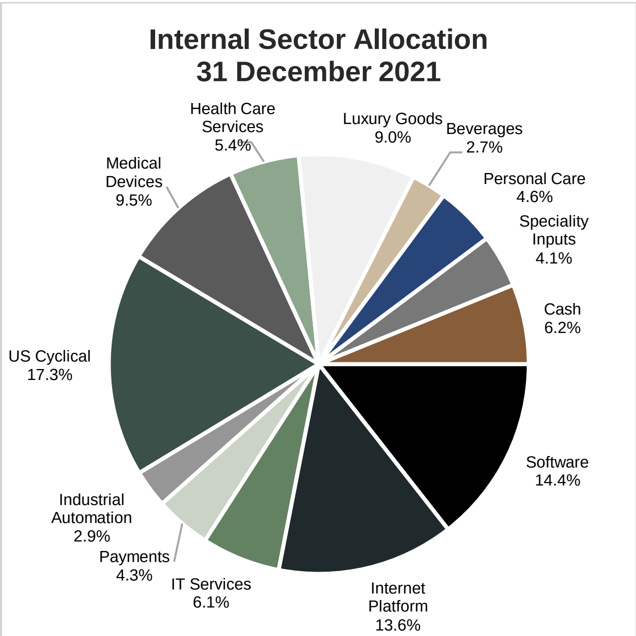
We thank you for your support through a highly unusual year in markets.

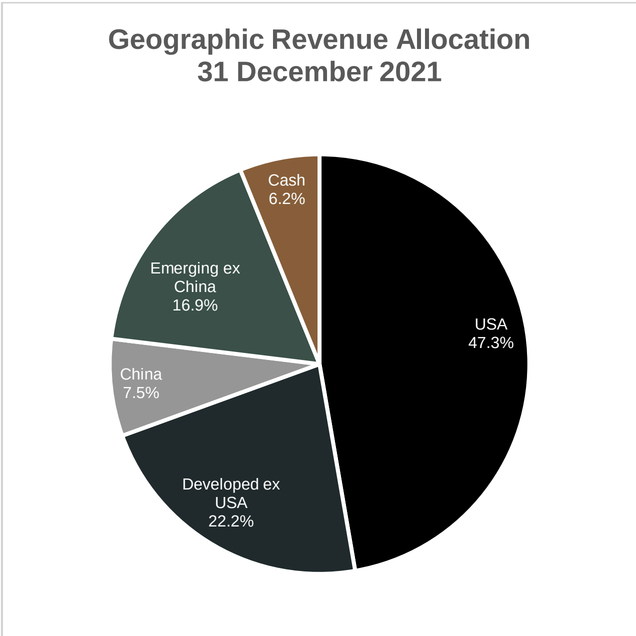
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021
Profitability			
Gross Margin	55.7%	49.8%	52.3%
Operating Margin	23.5%	20.1%	24.3%
Free Cash Flow Margin	18.9%	17.0%	17.6%
Returns on Capital			
Return on Assets (ROA)	13.0%	11.9%	13.7%
Return on Equity (ROE)	28.3%	24.9%	30.4%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%
Leverage			
Debt/Equity	87.2%	68.6%	78.3%
Net Debt/Equity	19.3%	22.1%	27.3%
Valuation			
Free Cash Flow Yield	2.8%	3.2%	2.8%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%
Holdings			
Number of positions	19	21	21
Active Share	86.5%	87.8%	89.0%

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
Constellation Software Inc.	Software
Estēe Lauder Companies	Personal Care
HEICO	US Cyclical
LVMH Moët Hennessy • Louis Vuitton	Luxury Goods
Microsoft	Software
Thermo Fisher Scientific	Medical Devices
UnitedHealth Group®	Health Care Services