Interim Letter
2022

Dear fellow investor

As the investment team of Constantia Investment Partners, we find ourselves writing to you during a volatile period in markets. We strongly believe that for the patient investor, opportunity for considered capital allocation abounds when volatility comes knocking.

Managing other people's money is a privilege that comes with a huge amount of responsibility. We plan to always justify your trust. Investors should always consider all four of us as being available to you telephonically, via email, or in person. If you have any questions about how we manage your capital, please do not hesitate to reach out to us.

Performance to 30 June 2022

	GHCF	Benchmark
Financial Year 2022	-9.9%	-6.5%
2022 (Calendar YTD)	-21.0%	-16.0%
2021	+31.1%	+29.3%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+24.6%	+21.9%
Annualized Since Strategy Inception	+8.1%	+7.3%

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.)

For the calendar year to date, returns have been negative, both in an absolute and relative sense. The only sector that generated a positive absolute return for calendar YTD to 30 June was energy. This divergence from the market return was largely due to the surge in oil, natural gas and coal prices resulting from the combination of the Russian invasion of Ukraine (and subsequent sanctions) and the structural, global underinvestment in energy supply over the last decade.

In our opinion, the sell-off in markets to 30 June 2022 had been indiscriminate. Quality businesses with longevity were sold off in line with meme stocks, crypto currencies, and companies that a) are one-hit wonders with no sustainable business model, b) generate no cash or c) are over-indebted. Focusing on the distinction between quality and everything else is where the opportunity lies for the patient investor to outperform the crowd. The crowd – in this case, the market – is many things, but it is not patient.

If markets were to weaken again over the next several months, we believe the incremental dollar put to work has a very high probability of earning an attractive return on a three-to-five-year view. We put our own money to work in the Fund in May and June, and plan to continue to dollar-cost average over the months ahead.

Creating alignment with you is paramount to how we manage Constantia. Our own capital is invested alongside yours in the Fund and also pays fees.

We always want to sit on the same side of the table as our investors, and we intend to further strengthen this alignment with time. We'll share more as we make progress on this front.

Conclusion

As inflation looks like it will remain elevated for the foreseeable future, our focus remains to both protect and compound your wealth in absolute, inflation-beating terms through the cycle.

An absolute return mindset is what underpins our long-term compound return objective of between 8% and 12% per year. While comparing us to a broad equity index may be of use in contextualizing our performance, we find that it invites thinking of the index as a “risk-free” default investment. Of course, nothing could be further from the truth.

We do not predict where market indices will head next, but there is certainly no shortage of dire predictions in the media. We acknowledge the near-term headwinds to global growth – hence our preference for owning well capitalised businesses that can withstand periods of economic uncertainty, and take advantage of weaker rivals' misfortunes to gain market share.

The rest of this letter will focus on a specific holding: Louis Vuitton Moët Hennessey (LVMH). We trust it will serve as an example of how we think about identifying, understanding and (if warranted) subsequently allocating capital to investment opportunities, even when faced with economic headwinds.

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.

Thank you for your continued support. Please reach out to us if we can help in any way.

Kind regards,

Etienne, Les, Dan & Andrew

LVMH: When Overnight Success Takes Decades to Build

by Etienne Vlok, Daniel Gerdis & Andrew Strasser

When you sit down to think about why luxury brands exist, you may arrive at a seeming conundrum: in virtually every category of luxury good or service, there are alternatives that provide the same practical utility (e.g.: telling the time, storing your luggage, providing a roof over your head for a European holiday or a drink to celebrate a special occasion) at much lower, more affordable price points.

To find an answer to this question, it is instructive to turn to history. In fact, we can go back thousands of years to the Egyptian pharaonic dynasties to find some of the first documented instances of luxury consumption. When the tombs of the pharaohs were discovered, there were plentiful examples of the dead being buried with their most prized possessions – partly to accompany them on their journey to the afterlife, but also to serve as a display of the grandeur of their power and accomplishment during their living years.

As luxury brand experts Jean-Noël Kapferer and Vincent Bastien (a former managing director of the Louis Vuitton *maison* within LVMH) point out in their seminal book *The Luxury Strategy* (KoganPage, 2012):

> *The moment we [civilization] become aware of our own mortality, the ultimate in luxury, well beyond any notion of possession or status, is to be able to live on – and live comfortably at that – after death. Every great civilization has come up with its own and often remarkable way of answering this craving for immortality. […] These religious roots are still relevant today: luxury is about elevation.*

This observation holds true across time and geography. Many ancient civilizations exhibit analogous approaches to funerary rites, burying their dead with prized luxury possessions. Over time, what was considered 'luxury' became democratised to the point that even the general population had access to what was formerly the exclusive province of the ruling elite.

Skipping ahead a few millennia, luxury consumption today obviously looks quite different, being less to do with religion and more to do with social signalling. However, the two principles outlined above – that luxury is inherently about social elevation, and that there is an inherent tension between said elevation and the diffusion of luxury goods and services to an increasingly broad section of the population – is as valid as ever.

For investment purposes, we believe we can safely arrive at two conclusions: 1) luxury consumption is not in the slightest about utility (a $50 Casio watch tells the time much pretty much the same as a $250,000 Patek Phillipe), but rather about the perceived social value attached to the consumption itself; and 2) that this trait seems hardwired into the human operating system. Once we achieve a certain level of success, income and wealth, there exists a natural tendency to want to indicate these accomplishments to society at large.

Marrying these two points to the Economics 101 concepts of supply and demand leads us to a further (and in our opinion, investable) conclusion: demand for true luxury goods – while cyclical – is relatively inelastic. In fact, for specific categories of luxury item, demand may (surprisingly) increase as the asking price goes up. The reason? The social signalling value depends on the price. As the price increases, the good 'changes' in the mind of the consumer. This observation is borne out by the long history of real (i.e., above-inflation) price increases that well-managed luxury brands have been able to achieve over decades.

All the above is not to say that luxury goods do not exhibit superior craftsmanship or durability than comparable 'normal' goods. As an example, the specialised skills that are required to create a Swiss watch takes years to acquire, even after an apprenticeship of several years. In many cases, luxury brands have differentiation wired into their manufacturing process. When associated with a demonstrable history of superior manufacturing (or, even better, a list of famous consumers over time), it provides luxury brands with that most indefinable yet valuable of moats: *heritage*. Said differently: in 2022, no one is successfully launching a high-end rival to the leather bags sold by Louis Vuitton or Hermes, because both of these brands have decades of history, becoming inescapably linked to significant cultural icons or moments.

Equally, while the barrier to entry in wine is generally capital, time, and a high pain threshold (confirmed to us by several winemakers we know!), displacing Château Pétrus in the eyes of luxury wine buyers is simply not on the cards.

Luxury consumption has been with us for millennia. While the forms of consumption have evolved, the social signalling value remains the driving force behind the purchase decision. Because the purchase price of luxury goods (and over time, the increase thereof) are generally not linked to the input costs in the mind of the consumer, the combination of pricing power and healthy margins (underpinned by the "buy commodities, sell brands" philosophy inherent to the luxury business model) tend to mean that well run luxury businesses can earn very attractive returns on invested capital and generate significant free cash flow. In short, well-run luxury businesses very much tick the boxes we look for in an investment.

Information with Long Shelf-Life & the Risks to the Luxury Business Model

You may rightly wonder what reading about Egyptian funerary rites or considering the economic nature that luxury consumption occupies in the mind of the consumer has on us deciding to invest in a business.

Much of the market's attention is always focused on that which is 'new' or exciting. Sectors or companies that meet these criteria can attract a lot of capital and investor interest quickly, leading to rapid price appreciation. However, in chasing the 'new' trend/theme/sector/business, it is by definition almost impossible to make an informed decision about whether it is *sustainable*. The 'new' generally hasn't been around long enough to draw any conclusions about durability. This concept bears out in the IPO market: a base rate analysis of past IPOs illustrates vividly that for every durable winner, there are a multitude of also-rans that fall into obscurity.

To quote from our 2021Annual Letter, sent back in January 2022:

> *[Instead of "what is new?"], 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. […]*
>
> *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. […] Asking "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.*

We seek information with a long shelf-life – the kind that doesn't expire after 90 days with each quarterly earnings release. Knowing next quarter's earnings would be invaluable if we intended to trade stocks over the short-term, but study after study suggests that this is not an easily repeatable way to generate outperformance. In contrast, we believe that the long-term returns we can generate will reflect the underlying returns on capital of businesses we own, hence our focus on trying to understand the drivers of return on capital.

When assessing luxury businesses, we believe that trying to develop an understanding of the drivers behind the psychology of luxury consumption through the ages place us in a far better position to identify the true risks to our investment thesis, rather than the (in our opinion) overly simplistic risk of "luxury underperforms during an economic slowdown or recession" – which is duly raised every time the economic outlook darkens. (We would immediately point out that the better-managed and more durable luxury businesses seem to always bounce back stronger for the next cycle – therein lies the opportunity for us as investors).

So, what are the big threats to an investment in a luxury business? We believe there are three.

1. The exclusivity of the brand becomes diluted, and the heritage moat is undermined.
2. The social acceptance of luxury consumption diminishes due to changes in the socio-economic or political landscape.

3. Real wages don't grow for an extended period, leading to a more permanent shift in consumer behaviour than the mere boom-and-bust of economic cycles.

Let us very briefly address each.

1. The greatest risk to any luxury brand is it becomes too diffused (or, said more plainly, that it becomes too affordable to the aspirational mass market buyer.) If luxury consumption is about social elevation, there is no worse sin a brand can commit in the mind of its most devoted buyers than devaluing the social signalling message by flooding the market with product, or by oversaturating the brand through excessive marketing. If everyone can afford it, is it luxury? Evidence would suggest not, at least from a social signalling standpoint. Recent examples of luxury brands that fell afoul of this challenge include Coach and Michael Kors. Coming back from this kind of brand damage is very difficult, from the available evidence.
2. Luxury consumption, by definition, is the realm of those who are not living hand to mouth. It is therefore always inherently a social issue, since it directly relates to matters of social stratification, the notion of practical utility vs. waste, and decisions made as to the distribution of wealth.
    a. Over the last 40 years, our globalising world economy (and generally improving GDP/capita) had meant that luxury consumption has largely been left unregulated. However, it is not impossible to foresee that this could change in a command-driven economy like China, should political and economic pressure steer popular opinion away from public displays of luxury consumption. Should such a change occur in China, it will disproportionately hurt luxury businesses, since the bulk of their marginal buyer has come from China over the past 15 years.
3. As mentioned earlier, luxury consumption is always cyclical, following the boom-bust cycle of the underlying economy. Luxury is almost always a 'feel-good' purchase, made when wealth levels have increased, and the future looks reasonably certain. This phenomenon is part and parcel of the luxury business model, and we don't consider this aspect an existential threat to a luxury business *per se* (barring excessive debt levels prior to the arrival of the slowdown).
    a. However, an <u>extended</u> period of economic hardship eventually has a way of changing habits in ways that stick: the Silent Generation (children during the Great Depression and through World War II) were notably more reticent to 'pay up' for any product or service, preferring to be thrifty and get the most out of their hard-earned income. Only a generation later did excessive consumerism again become a driving force in society. To some extent, this highlights an earlier point – that luxury consumption is hardwired into human behaviour, provided that prevailing economic conditions are favourable.

While seeming perhaps outlandish, we believe these types of changes represent far greater long-term risks to the luxury business model than normal cyclicality or technological disruption (unlikely in our opinion, as most luxury purchases are made because of the heritage aspect imbued in the product, and outright utility doesn't frequently enter the purchase decision framework).

If we want to be long-term owners, thinking about risk requires us to seek long-term answers. While financial analysis is good at telling you what has happened, discerning the many potential future outcomes requires taking a broader perspective.

A Brief History of LVMH

Many people think of LVMH as a luxury business. While true, we think a more accurate description might be "a holding company and capital allocator with operating excellence in diverse luxury markets" – quite a mouthful, but an important distinction, in our view.

LVMH has acquired each and every one of its world-leading brands, starting with the purchase and merger of fashion house Louis Vuitton with wine & spirits producer Moët Hennessy in 1987. Acquisition by acquisition, CEO and chair Bernard Arnault has expanded the resulting entity (LVMH) into watches, jewellery, perfumes, cosmetics, high-end-fashion, -retailing, -hotels and -spirits. In fact, we find it noteworthy that LVMH has never successfully launched an in-house luxury brand that survived more than a few years before being shut down, illustrating just how hard it is to do.

Arnault himself is sometimes referred to as the ‘Wolf in Cashmere’ for his famously hard-nosed dealmaking approach, though it is difficult to argue with the results since he took over the reins. One thing LVMH management has consistently emphasised over many years is that “it takes time to build a strong luxury brand”. Under the scrutiny of public ownership, the incentive for luxury brand owners is always to cut corners to drive short-term profitability. Pushing volumes through wholesale retailers at the cost of control over the product, or embarking on high-margin, brand-dilutive licensing forays are notable examples that have been tried elsewhere, largely to disastrous long-term effect.

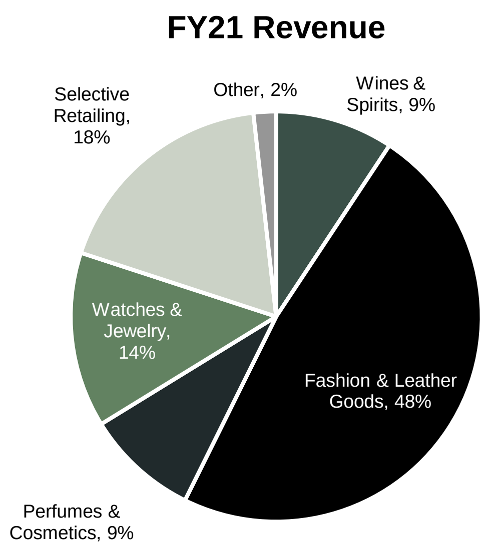
LVMH’s approach to allowing their brands to grow and mature organically in the hearts and minds of their consumers speaks to how well the business has managed the inherent tension between the aforementioned “diffusion vs. desirability” dynamic. When it comes to luxury goods, success and growth counterintuitively leads to problems for the brand owner, as growth can lead to perceptions of the brand becoming ‘too mass-market’, and thereby undermining the perception of exclusivity and ultimately the ‘heritage’ moat. Successfully navigating this challenge requires both discipline and a very firm grasp of the brand identity, allowing for desirability to increase at a faster pace than diffusion (i.e., the availability of product). When executed well, the consistency of pricing power that flows to the brand owner as a result of this strategy is nothing short of extraordinary.

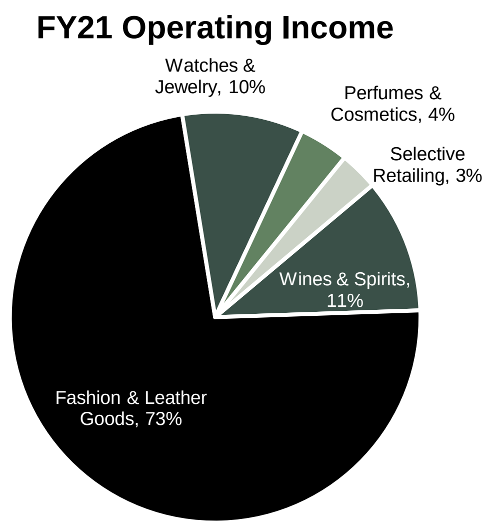
When it comes to all things luxury, patience is a virtue. A (relatively) recent example that made it to the Financial Times: in 2004, LVMH acquired Glenmorangie, producer of single malt Scotch in the Scottish Highlands. Glenmorangie, in turn, had acquired Islay-based Ardbeg in 1997 for approximately £8mn. Under LVMH’s ownership, Glenmorangie had been afforded the time to develop Ardbeg into an incredibly niche whiskey brand with a loyal following. The result? In 2022, a single cask of 1975 Ardbeg sold to a collector for £16mn in a private sale: literally twice what Glenmorangie had paid for *all* of Ardbeg – its assets and stock of inventory – in 1997.

LVMH in 2022

LVMH today comprises of 75 Maisons, which it groups into 5 segments in its financial reporting:

- Wines & Spirits (e.g., Moët & Chandon, Dom Pérignon, Veuve Clicquot, Hennessy)
- Fashion & Leather Goods (e.g., Louis Vuitton, Christian Dior Couture, Celine, Loewe, Givenchy)
- Perfumes & Cosmetics (e.g., Christian Dior, Guerlain, Givenchy, Acqua di Parma)
- Watches & Jewellery (e.g., Tiffany, Bulgari, Chaumet, TAG Heuer, Hublot)
- Selective Retailing (e.g., Sephora, Le Bon Marché, DFS Group)





Source: LVMH Financial Statements, Constantia analysis

Fashion & Leather Goods make up the majority of LVMH's revenue and operating income, and is the company's most profitable segment. Wines & Spirits and Watches & Jewellery each contribute a smaller percentage to LVMH's operating income. Watches & Jewellery has materially increased in the mix following the acquisition of iconic US jewellery maker Tiffany & Co in January 2021. Perfumes & Cosmetics and Selective Retailing each contribute a smaller percentage to operating income, with the latter – containing Sephora and department store Le Bon Marché – being the lowest margin segment.

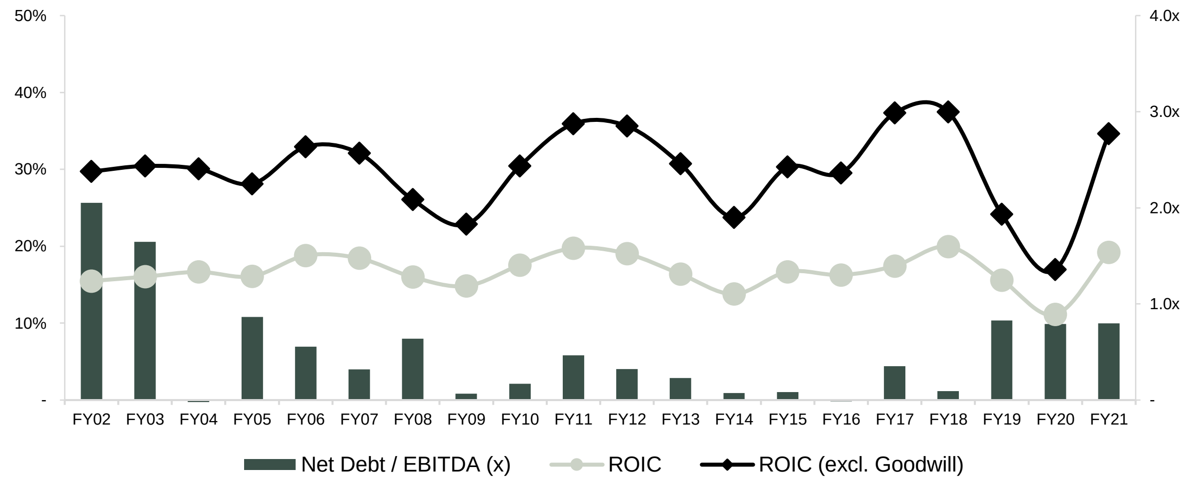
Operating income margin (%)	FY17	FY18	FY19	FY20	FY21
Wines & Spirits	31%	32%	31%	29%	31%
Fashion & Leather Goods	32%	32%	33%	34%	42%
Watches & Jewellery	11%	14%	13%	7%	29%
Perfumes & Cosmetics	16%	17%	16%	2%	8%
Selective Retailing	8%	10%	9%	(2%)	5%
Total	**20%**	**21%**	**21%**	**18%**	**27%**

Source: LVMH Financial Statements

Business Quality

We consider LVMH to be an exceptionally high-quality business with an enduring competitive advantage: the heritage brand strength of its *Maisons* (literally, "house"). These brands and the pricing power they lend to LVMH's products sees the company earn gross margins in the region of 60% and operating margins in the high 20s. As outlined earlier in this letter, we believe such a competitive advantage is difficult to disrupt given the inherent time horizon required to develop a 100+ year heritage brand. It is simply unlikely that there will be new 'true luxury' competitors popping up overnight. You can't fake heritage.

Despite being fully integrated – from raw material sourcing all the way to directly selling to consumers – for many of its *Maisons*, LVMH earns high returns on invested capital. What's more impressive, is that despite the company's acquisitive history, returns on invested capital have remained attractive, suggesting they rarely over-pay. Additionally, all of this has been achieved without over-gearing the business, with LVMH rarely ever reaching above 2.0x net debt / EBITDA. Given the strong performance of the Tiffany acquisition, we anticipate that LVMH will be largely debt-free by the end of 2022 – an enviable position to be in, as a capital allocator.



Source: LVMH Financial Statements, Constantia analysis

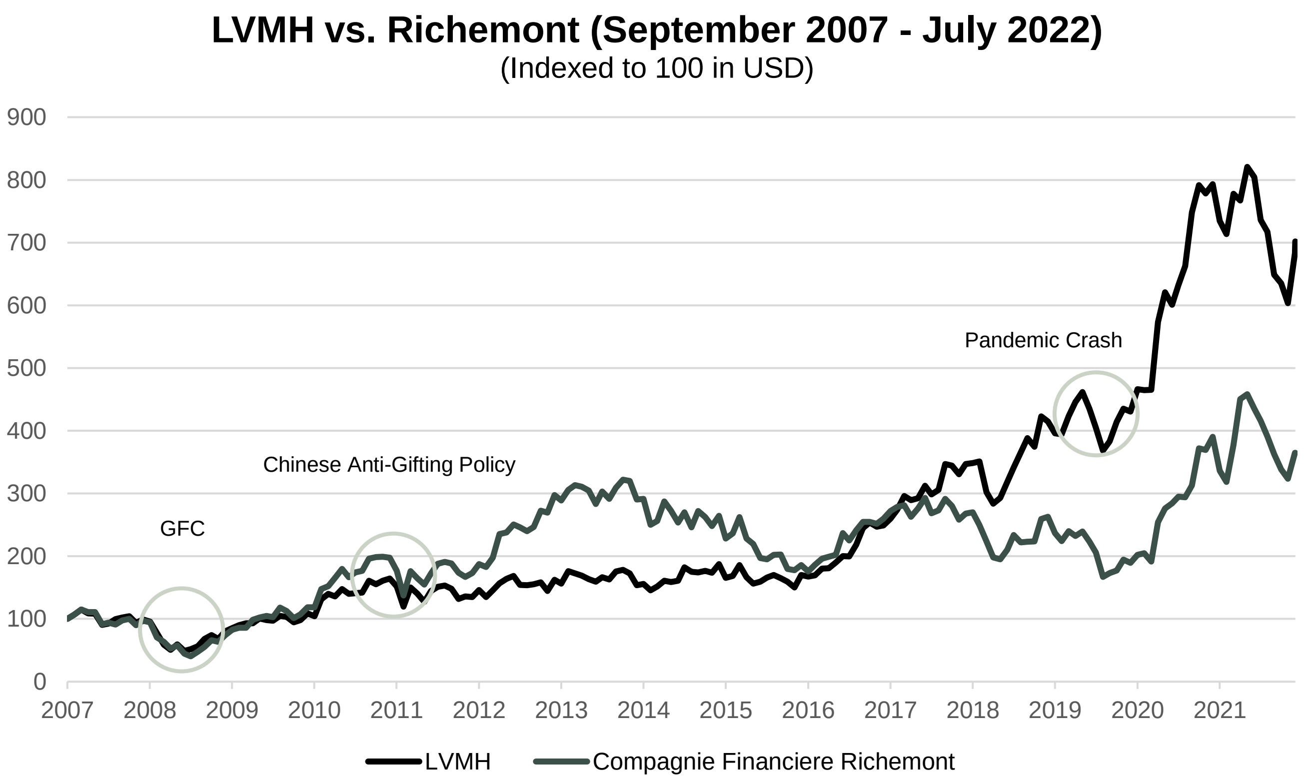
Material changes in the luxury industry can take decades – in some cases centuries – to play out, with capital allocation being a game of patience. By remaining lowly geared and well capitalised, we believe LVMH will remain a willing buyer for other high-quality brands should the opportunities present themselves.

This history of astute capital allocation and conservative financing speaks volumes of management's ability to steward shareholder wealth. And this makes perfect sense given that CEO Bernard Arnault and his family own ~47.5% of the company. They are the ultimate example of an aligned owner-operator with a long-term time horizon. Arnault has stated his intention for the business to succeed over the course of generations by grooming his successors, and we feel comfortable partnering with such a meaningfully invested owner-operator.

Acting Rationally When the Market Is Irrational

We believe that hoping to time the bottom of the market is a futile endeavour, which is why none of our time or energy is dedicated to doing so. What we can control is understanding the fundamental quality of a business, both in absolute terms and relative to peers. This 'business-first' approach – investing in the most durable business in an attractive sector, coupled with a patient investment horizon – allows for exceptional compounding through time.

By way of example, the graph below illustrates the prices of both LVMH and luxury watch conglomerate Richemont, indexed to 100 and converted to USD at the starting point to allow for a direct comparison. Both are well-regarded luxury brands, steeped in heritage.



Source: FactSet.

We believe there are two key takeaways from this graph, speaking to a) owning the most durable business in a sector, and b) the fact that this approach doesn't require an investor to time the market.

- *Remaining invested through the cycle:* during the Global Financial Crisis (GFC) of 2008/2009, both LVMH and Richemont more than halved before subsequently fully recovering (although said recovery took the better part of a year). Thereafter, both materially appreciated in subsequent years as demand for luxury goods picked up again. As an investor in either of these durable companies going into the GFC, you would have been handsomely rewarded over the following decade and a half via share price appreciation if you had merely closed your eyes and done nothing. However, the outperformance of LVMH (which we would argue is demonstrably the best-in-class luxury business, both in hindsight and looking forward) would have returned almost twice (1.9x, to be exact) the share price appreciation of Richemont. Owning the better-quality business with a demonstrable track record of superior capital allocation has paid off in spades, with LVMH compounding at ~14.9% per annum (a 583% return) over 15 years. Richemont delivered a return of ~9.7% per annum (a 264% return) over the same period. Ultimately, we would argue that the better business quality (expressed through the greater internal diversification, the talent and capital allocation ability of management, and desirability of its products) has driven the outperformance of LVMH. The patient investor in high quality businesses did not need to act at all during the GFC (or for that matter the pandemic crash or dotcom bubble), as the fundamental business quality delivered a return that not only exceeded luxury peers, but also our targeted through the cycle 8-12% return objective.

- *Patiently adding to your investment:* the investor who had the fortitude to add to their shareholding in LVMH by topping up their investment during the GFC drawdown saw outsized gains in the years that followed. While understandably never easy to do in practise, our duty when allocating your capital is one of removing the emotional biases to investing and taking advantage of near-term market mispricing (such as the 25% correction in LVMH's price in the first half of this calendar year). We do not try pick the bottom of the market, as this has an exceedingly low probability of success. Instead, we patiently increase the Fund's positioning to durable businesses like LVMH when near term pricing presents an opportunity for outsized medium-term returns.

Conclusion

To us, LVMH has an enviable track record of value-creating capital allocation over many decades. As a result, we classify it as one of the six businesses currently owned in the Fund where the main line of business is 'capital allocation' – it just so happens that the end market (luxury) is also incredibly lucrative.

When investing in such businesses – where counter-cyclical capital allocation can create value by using the balance sheet at the appropriate time – we think of ourselves as truly 'partnering' with management when we purchase their stock, and we look for opportunities to increase our ownership with a margin of safety. We are of the opinion that *Monsieur* Arnault and family are unlikely to sell their interest in LVMH for anything other than a truly stunning premium in a private transaction – and yet we as public equity investors are afforded, from time to time, the opportunity to sit on the same side of the dealmaking table as them when the market sells off LVMH on short-term concerns.

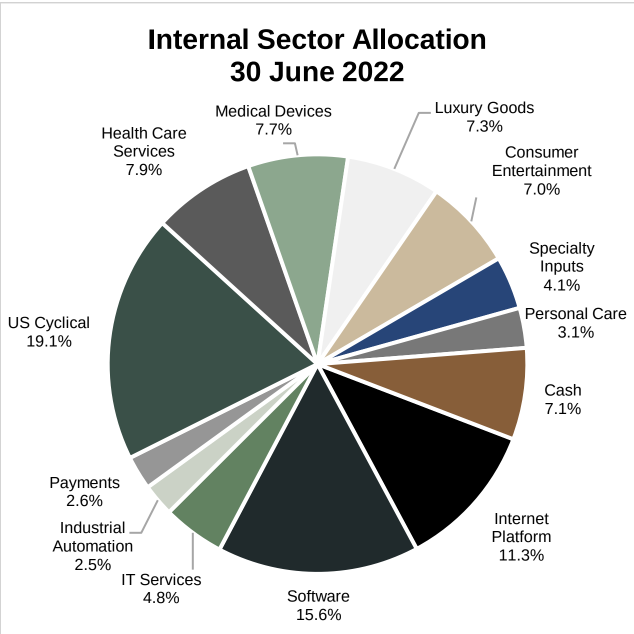
This is where our opportunity lies: when the market prices a high-quality business with durable competitive advantages like an average business. It requires patience, but we gladly take advantage of such opportunities when they come along.

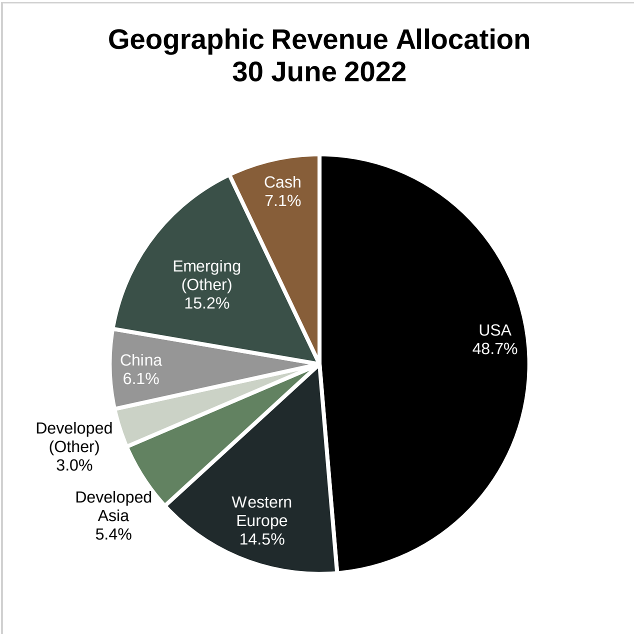
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	June 2021
Profitability				
Gross Margin	55.7%	49.8%	52.3%	50.1%
Operating Margin	23.5%	20.1%	24.3%	21.9%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.2%
Returns on Capital				
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.3%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.9%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.6%
Leverage				
Debt/Equity	87.2%	68.6%	78.3%	74.4%
Net Debt/Equity	19.3%	22.1%	27.3%	25.4%
Valuation				
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.9%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	4.6%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	5.4%
Holdings				
Number of positions	19	21	21	21
Active Share	86.5%	87.8%	89.0%	89.2%

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
Fastenal	US Cyclical
HEICO	US Cyclical
Microsoft	Software
Nintendo	Consumer Entertainment
ThermoFisher Scientific	Medical Devices
UnitedHealth Group	Health Care Services