Constantia Investment Partners

Annual Letter
2022

Dear fellow investor

In 2022, the AIM Global High Conviction Fund (GHCF) delivered a return of -15.56% after all fees. By sheer happenstance, this decline works out to almost precisely 50% of the +31.14% return delivered in 2021, meaning we have essentially ‘given back’ half of last year’s advance.

Considering the numerous challenges presented by 2022 (a non-exhaustive list includes: 40-year high levels of inflation across many economies; the Federal Reserve rapidly increasing interest rates by more than 4% in response; the Russian invasion of Ukraine leading to soaring energy and food prices; a deteriorating geopolitical backdrop as great power competition between superpowers made a comeback), ending the year with a drawdown of -15.6% is not the worst outcome. Certainly, if a year ago you had told us all the above would occur simultaneously in 2022, we’d have expected markets to be down a lot more.

This statement should not be taken as us being ‘happy’ with posting a negative return for 2022. All of us at Constantia are meaningfully invested alongside you, and none of us like seeing a minus-sign on our statements. However, being long-only investors, we understand that negative years are part and parcel of market cycles, and declines are therefore inevitable.

Far more important to our approach of stewarding your capital is ensuring that the *businesses* we own on your behalf are fundamentally performing well: generating attractive returns on capital, which aligned management teams then rationally allocate to create value for us as shareholders. On this front, developments have been more positive.

Performance to 31 December 2022

	GHCF	Benchmark
Financial Year to Date 2023	+6.9%	+4.4%
2022	-15.6%	-12.2%
2021	+31.1%	+29.3%
2020	+14.2%	+5.6%
2019 (Strategy Inception: 31 Aug. 2019)	+5.3%	+6.3%
Cumulative Since Strategy Inception	+33.2%	+27.3%
Annualized Since Strategy Inception	+9.0%	+7.5%

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

The goal of our interim and annual letters is to inform our investors about the businesses we own on your behalf, discuss the drivers of our performance, reflect on lessons learnt, and provide some sort of "best guess" as to what may come next. Our annual letter will always be the most detailed of our communications to you.

There is an old proverb in the investment management industry which states that as markets decline, client letters tend to get longer. In our time-starved world today, writing a 30-page missive will probably fail to achieve any of the goals outlined above because very few people are likely to read all the way through. With that in mind, we have tried to keep this annual letter concise. (It comes in at two pages shorter than our 2021 letter: an extremely modest contribution to the battle against inflation).

If the letter is deficient about any detail you are interested in, you should absolutely reach out to us directly via telephone or email. We are happy to answer any questions.

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 the way we feel is most logical. To help with navigating this document, those reading it digitally can simply click on the underlined text below to jump directly to the relevant part of the letter.

- In **Part One**, we provide an overview of the drivers of performance for the year, along with some thoughts on market conditions.
- In **Part Two**, we reflect on some broader market observations and lessons learnt in 2022
- **Part Three** discusses one of our portfolio holdings (online marketplace Etsy Inc.) in some detail.
- Finally, **Part Four** provides some concluding thoughts on the year ended, as well as an outlook for 2023.

As is customary, we include our usual quality scorecard (which now includes historical metrics to allow for comparison), internal sector allocation, geographic revenue exposure, and the top ten holdings as an addendum at the back.

In Closing

Managing other people's money is a privilege that comes with a huge amount of responsibility. We do not take this responsibility lightly, and deeply appreciate the trust you have placed in us.

Thank you very much for your support during a volatile year. We look forward to the road ahead.

Kind regards,

Etienne, Les, Dan & Andrew

Part One: CY22 in Review

by Etienne Vlok

We invest with an absolute return mindset, and target returns of between 8% and 12% per year through the cycle. Our -15.6% return in 2022 fell far short of this target. While this outcome is certainly not to be celebrated, we return to what we wrote in our 2021 Annual Letter (after a much stronger year):

> *We would caution investors against mentally extrapolating the rate of return we have delivered this year [2021]. 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.*

With this in mind, as of 31 December 2022, our 3-year compound return of +8.1% is marginally within our target range, whilst our +9.0% per year return since strategy inception (31 August 2019) is closer to the middle.

We acknowledge that playing the ‘we are long-term investors’ card may be seen as somewhat long in the tooth, as it is an excuse that can be used to obscure a multitude of poor investment behaviours. Biology (and psychology, for that matter) tells us that humans are hard-wired to prefer a bird in the hand over two in the bush. We’ve been around long enough to know that talk of better future returns rings somewhat hollow after a weak year. (As the expression goes: ‘talk is cheap; money buys the whiskey’). Yet, we also know that the real world is a messy place, and – reflecting this reality – markets move about in messy ways.

The fact that humans are wired to react to immediate feedback means that the lag that exists between an investment decision and the eventual reward is tough to swallow. The goal of this section is to a) provide a succinct explanation of what drove our returns in 2022 whilst b) clarifying the rationale behind the long-term decisions we have made.

Absolute Returns

It was a down year, so in the spirit of intellectual honesty, let’s start with the bad news.

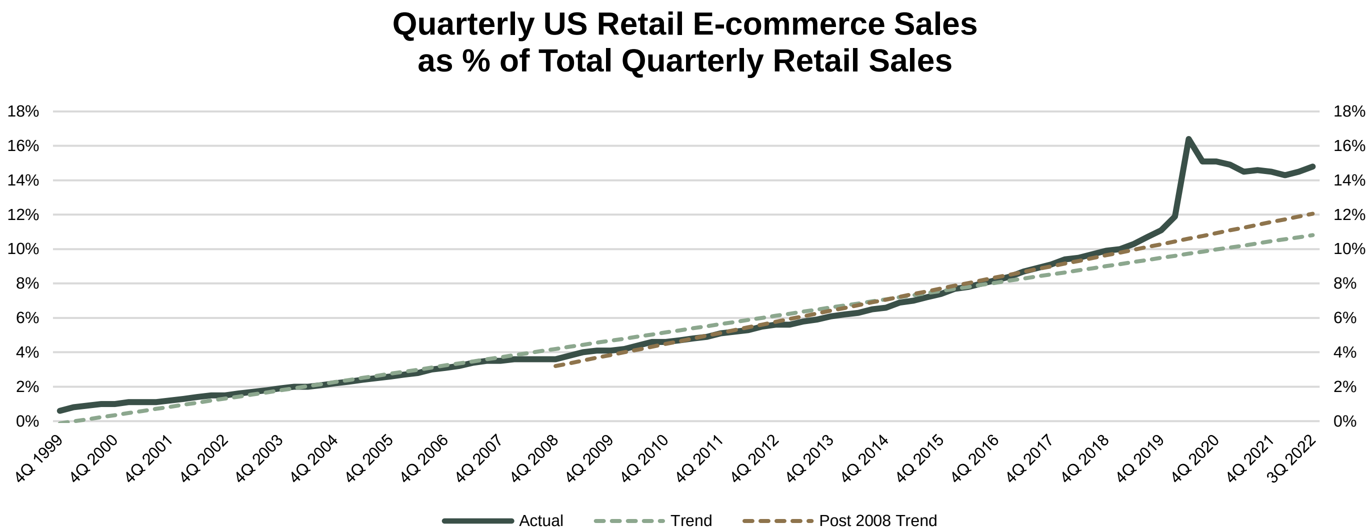
The five greatest detractors cost us a combined -8.9% in absolute terms. The relevant businesses were Amazon.com (-46.0% in AUD), Intuitive Surgical (-43.8% in AUD), Croda International (-37.0% in AUD), Alphabet (-34.3% in AUD) and Accenture (-30.1% in AUD). While not a top five detractor, Etsy Inc. (-41.4% in AUD) also bears a mention, as its total return was among the weakest in the Fund.

Croda and Accenture experienced no material weakening of their businesses or their long-term prospects. In our opinion, their negative return is most likely linked to the rapid rise in discount rates, and merely reversed some of their gains of the year prior. Intuitive was expensive at the start the year, trading on a free cash flow yield of 1.3%. It was sold over the course of 2022 as we feared that demand for its *Da Vinci* surgical robot would be pressured as health care capital budgets came under increasing strain in a slower-growth, more indebted world.

Amazon, Alphabet and Etsy share common attributes: all three are online platforms focused on retail or advertising. As a group, these businesses were some of the biggest winners during the pandemic; in 2022, the category was among the worst performing. We believe there are two reasons that explain their weak performance.

- Higher discount rates dragged down valuations across the board. In the case of Amazon and Etsy, the cash flows may have been farther out in the future and the valuation therefore more demanding, but Alphabet was not a dramatically expensive stock heading into 2022.
- Investor expectations for the future of these businesses came down materially over the course of the year.

In our opinion, the chart below (sourced from the US Department of Commerce Census Bureau) addresses the second point above rather succinctly: it shows the penetration of online sales as a percentage of total retail sales in the US on a quarterly basis, going back to December 1999.



As can be seen, there is a huge spike in the penetration of online sales over the first half of 2020 as a result of lockdowns negatively impacting brick and mortar retail. From the peak level of 16.4% (June 2020), penetration has dropped back as physical retail made a comeback.

With the benefit of hindsight, markets (ourselves included) over-extrapolated the level of online sales seen during 2020, albeit to varying degrees. As shoppers went back to their old habits in 2022, most online retailers experienced headwinds and a lowering of investor expectations.

Worth noting, however, is that online shopping as a percentage of total US retail sales is settling at a much higher level than a continuation of the pre-pandemic trend would suggest. We are of the belief that the penetration of online retail will continue to grow over time, but clearly, expectations were simply too lofty headed into 2022.

Interestingly, investors were not the only ones to over-extrapolate the online retail trends of 2020. Management teams of online platforms did the same, investing heavily to be able to service new demand. This overinvestment partially explains the underperformance of these stocks this year: a slowdown in revenue growth combined with higher costs lead to a margin squeeze. Amazon, for example, had to make decisions about capacity expansion in August and September 2020 for distribution centres that would only come online in the final half of 2022. Management invested on the assumption that the capacity would be required on this timeline. While this turned out to be over-optimistic, we don’t think it’s capacity that will *never* be utilised, implying future margin improvement.

Alphabet underwent a similar period of investment, although in their case the focus leant towards hiring skilled workers. The end-result was the same, though: a margin squeeze. From current valuations levels (a FCF yield of around 5.5%), we don’t think Alphabet is heroically valued, and there are numerous areas where we believe management can prudently cut costs without impacting the long-term viability of the business.

We discuss Etsy – a stock that took up a lot of our time and energy in 2022 – later in this letter. We think it provides a good example of how we approach not only this case, but any investment opportunity with longer duration cash flows.

On the positive side, there is UnitedHealth Group (+14.7% in AUD), Berkshire Hathaway (+10.8% in AUD), an as-yet-undisclosed position, Games Workshop (+5.1% in AUD), Mastercard (+3.5% in AUD) and Coca-Cola (+3.1% in AUD). The latter two businesses were sold over the course of the year. Some positions purchased in the 4th quarter of 2022 also delivered a positive contribution, but they have not yet been held for long, and therefore their individual contribution is marginal at this stage. In total, all our contributors added up to a +3.1% positive impact.

By and large, the businesses that did well for us in 2022 were outside the technology sector, highlighting the benefits of maintaining balance when constructing a portfolio. Berkshire Hathaway – which derives a fair portion of its value from energy assets – serves as a good illustration of this.

Relative Returns

The largest driver of our *relative* underperformance was our lack of exposure to the energy complex, which outperformed the broader market by nearly 70%. Years of curtailed investment in new supply and the impact of sanctions on Russian oil and natural gas following the invasion of Ukraine combined to create a perfect storm of supply/demand imbalance, causing energy prices to soar.

Even as energy prices have moderated into the year-end on the fears of a global recession, the market re-assessed the duration of the cash flows that energy companies would deliver. Where it was previously assumed that these businesses were in terminal decline, the dynamics of the energy market in 2022 highlighted that it would be years before our economies would be weaned off coal, oil, and natural gas. As a result, a combination of strong growth (driven by higher energy commodity prices) and more positive sentiment towards the group as a whole lead to stellar returns in the space as valuation multiples expanded.

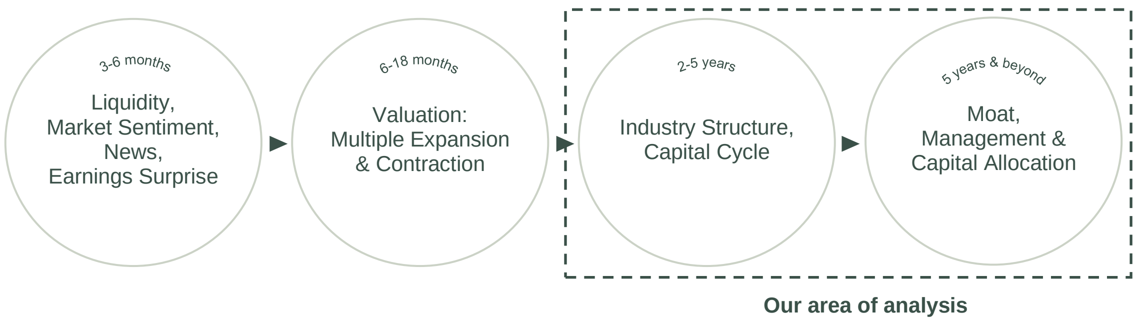
In Closing

We take a long-term approach when investing. 75% of the businesses owned in the Fund by the end of 2022 were owned as of December 2021 (and one year is a *very* short period in markets over which to judge that metric, in our books). Because our strategy is focused on the compounding ability of the underlying businesses we own, we expect this number to remain high (or trend even higher) over time.

As previously mentioned, we are by no means indifferent to a year of poor returns, but we are equally not looking for the nearest sword to fall on. If you will forgive another quote from our 2021 letter:

> *[…] 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.*
>
> *Trying to predict sentiment 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.*

The image below lays out these concepts, and highlights where we focus our analytical efforts.



Our research process leads us to high quality businesses (in short: companies with clean balance sheets, earning high returns on capital, generating excess cash, and managed by aligned management teams with a grasp of value creation and capital allocation principles). Our portfolio construction process leads us to maintain balance in how the Fund is constructed. In combination, these two factors should see us through the tough years in reasonable shape.

What is required from us is the intellectual honesty to recognize analytical errors when we make them, and the wherewithal to stick to the conviction of our beliefs when our analysis indicates we are not in error, but that our patience will be rewarded in the fullness of time.

Part Two: Observations from 2022

by Andrew Strasser

Successful investing requires being able to continuously learn, reflect and adapt. Every year, we put pen to paper to document some of the key lessons or observations from the preceding period. In some cases, the lessons are novel; in others, they merely re-affirm good behaviours. Below is a selection of observations from 2022.

Portfolio Balance is Vital

In last year's annual letter, we noted that a key to navigating 2021 was to maintain portfolio balance. Whilst it is perhaps unoriginal to re-use this observation, we believe it is once again a major lesson from 2022, and something all investors should keep in mind.

The past year saw a major reversal of sector leadership versus the prior decade. Many previous winners which benefited from the ultra-low rates regime saw their valuation premiums collapse as central banks embarked on a rapid hiking cycle. Sectors which meaningfully outperformed over the previous decade materially lagged the benchmark in 2022. (Conversely, the energy sector – with generally much cheaper starting valuations – delivered dramatic outperformance). Unsurprisingly, the worst performing investment style in 2022 – both in absolute and relative terms – was technology-focused growth.

Whilst one year's worth of poor absolute and relative performance for any strategy does not discredit its long-term return potential, the extreme volatility experienced by investors in single-thematic or single-sector funds illustrate that the ride can be particularly bumpy when owning a very concentrated portfolio of highly correlated positions.

We were by no means immune from the relative underperformance. As explained in Part One, this was mostly due to our limited exposure to the energy complex. Berkshire Hathaway's private ownership of Berkshire Hathaway Energy provides us with some indirect exposure, and it is therefore not surprising to see Berkshire as one of our best performing positions in 2022.

By maintaining balance in the portfolio and avoiding the temptation to become a one-way bet on technology-focused companies, we thankfully steered clear of being in the far left-tail of returns. In our opinion, relying on the assumption that 'what has worked over the past decade will continue to do so going forward' is a risky one to make. Balance in a portfolio is vital to protect against a range of potential future outcomes, not all of which can be foreseen at the outset.

Flexibility of Investment Strategy

As we quoted in our March 2022 letter, 'there are decades when nothing happens, and weeks in which decades happen'. The first quarter of 2022 was a clear example of the latter, following a sudden change in the Western interest rate regime and the return of war to Europe.

In the subsequent three quarters of the year, the groundwork has been laid for a decade that may look very different from the last, with stubbornly higher levels of inflation, interest rates well above zero, and increasing geopolitical tensions. If an investment strategy can only perform well in the era of free money and increasing globalisation, then it is unlikely that such a strategy will do well should those macro trends reverse, as they appear to be doing now.

To us, it is therefore vital that an investment strategy be robust and flexible enough to pivot in the face of a material change in the investing environment. We believe a quality-focused strategy (concentrated on the analysis of business fundamentals, management incentives, capital allocation and cash generation, and backed up by valuation discipline) provides sufficient flexibility in scope to do so.

We don't set out to invest in 'themes' or 'big ideas'. We look to own quality businesses that can compound in value.

Cash Generation Matters

Cash generation *always* matters. Some of the best performing stocks of the last decade (and particularly from 2019 to 2021) were so-called 'profitless' growth companies. These businesses were unprofitable due to them spending extraordinary amounts on attracting (and retaining) talent, as well as aggressively attempting to gain market share. In many cases, shareholders were asked to foot the bill at sky-high valuations to enable management in their pursuit of such aspirations, usually through capital injection at IPO or follow-on equity issuances. (Though not related to cash flows – and thus beyond the scope of this point – we should note that many shareholders were also fleeced through excessive dilution of their ownership, due to high levels of share-based compensation).

Unfortunately for shareholders, the valuations these companies attracted in previous years have fallen precipitously. Future cash flows that underpin intrinsic value are now being discounted at higher interest rates, resulting in a materially lower present value being attached to them. Moreover, against a backdrop of slowing growth and a weakening economic outlook, it's likely these cash-consuming companies will have to come back to shareholders cap-in-hand for more capital, negatively impacting the prospective return of the investment and reducing the relative attractiveness of the investment opportunity.

Revenue is vanity, profit is sanity, but cash is king. At some point, every business must generate cash – a lesson that may have been left by the wayside as companies became used to copious amounts of surplus capital during the free-money era of the past 12 years.

Internally Generated Cash is Oxygen

In the previous observation, we described a company that relies on external capital sources to fund its growth. When liquidity in the financial system becomes less abundant, raising capital externally becomes much more costly. The cost of funding for debt goes up, and the valuations that equity capital providers are willing to pay go down.

Compare this to a business that is able to fund its own growth through internally generated cash flows. In the face of slowing organic growth, a cash-generating business can continue to allocate capital to take advantage of market conditions at the expense of competitors that are cash constrained, with the goal of gaining market share in the process. Fast forwarding a few years, the cash-generating business that could press its advantage in a downturn is very likely both a larger and more competitively advantaged business.

If opportunities to grow are not available, management can simply choose to return cash to shareholders in the form of dividends or share repurchases, both of which can create meaningful value. In the case of share repurchases, management can deploy capital to increase future cash flow per share by reducing the share-count. Better yet, when this is done during a period of share price weakness, the result is a larger volume of shares repurchased, providing equity owners with a greater buyback yield.

To a business, cash is oxygen: during the good times, you normally do not notice its presence, but should it disappear during the lean times, you are in deep, deep trouble. As any tenured management team worth their salt will tell you, being *asset-rich* means very little if you are *liquidity-poor* when the tide goes out.

Managing Risk and Maintaining Buffers

It may seem obvious to state, but in times of rising interest rates and falling asset prices, it pays to have a buffer to avoid being a distressed seller.

2022 saw a major dislocation between buyers and sellers across many asset classes, not just equities. Sellers wanted to sell at the prices they'd been offered in 2021, whilst buyers were waiting for future bargains. The result was significant market volatility. For the long-term investor, this volatility is just a part of the journey. If an investor has conviction in what they own, they should be willing and able to ride out such periods.

However, volatility can wreak havoc on investors who are forced to sell to service short-term obligations (such as a margin loan) at the worst possible time. This is a succinct explanation of why we avoid using leverage in the Fund: the risk of interrupting the process of compounding by being a forced seller at depressed prices is simply too great to accept. On this topic, our motto is ‘in order to finish first, you *must first finish*’.

Conversely, when an investor is forced to sell a business at a depressed value, there is always a buyer on the other end. This buyer – having maintained a buffer – can then name their price, and in the process is likely to pick up bargains. This is what excites us about the year ahead. We aim to be a buyer of high-quality companies from distressed sellers, should the opportunities present themselves.

Part Three: Etsy Inc. – Handmade for You

by Daniel Gerdis

We seek to invest in companies with sustainable competitive advantages that can be enhanced over time by astute management teams. A well-known example of a sustainable competitive advantage is the network effect. Formally, the network effect can be defined as 'the value of a product/service increasing as the number of people who use the product/service increases'. A typical example of this would be a social network (Facebook, Instagram, etc.).

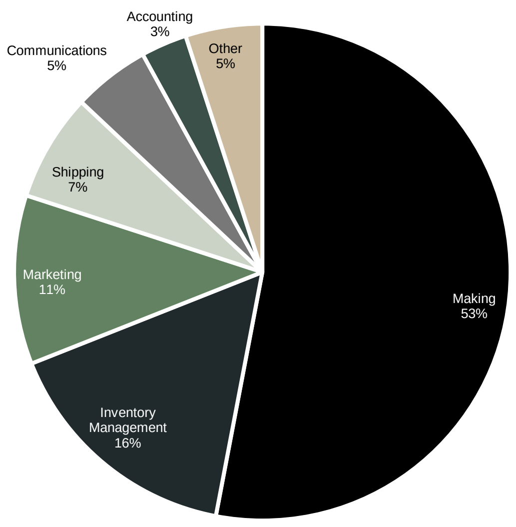
In Etsy, we see a great example of a strong network effect, connecting buyers and sellers on a two-sided marketplace for handmade items. The breadth and depth of participants and inventory is the lifeblood of any successful marketplace. As more sellers choose Etsy as a preferred sales channel, this attracts more buyers, which in turn attracts more sellers – a virtuous cycle that makes network effects a powerful source of competitive advantage.

We would argue the niche that Etsy has carved out for itself in being the go-to marketplace for handmade goods is largely unassailable by would-be competitors. Combined with an inherent 'capital-light' business model, we believe the business has a long runway ahead to continue growing.

Etsy has become synonymous with being the go-to destination for all things handmade, unique or one of a kind. Sellers on Etsy generally do not compete on price with other sellers or platforms; frequently, their products are tailored to the specific requests of the buyer, and in most cases, no equivalent can be purchased from Amazon or at the local Walmart. In fact, more than 90% of the sellers on Etsy are one-person businesses who spend more than half of their time making the items that they sell.

These sellers typically do not have the time nor inclination to search for buyers, or to run complex advertising campaigns online. They also lack the scale and leverage to negotiate competitive deals on shipping rates. Instead, they rely on Etsy to achieve all of the above (and more), enabling them to focus their time and energy on delivering a unique product and personalised customer buying experience.

How Etsy Sellers Spend Their Time



Source: Etsy Seller Survey, 2021

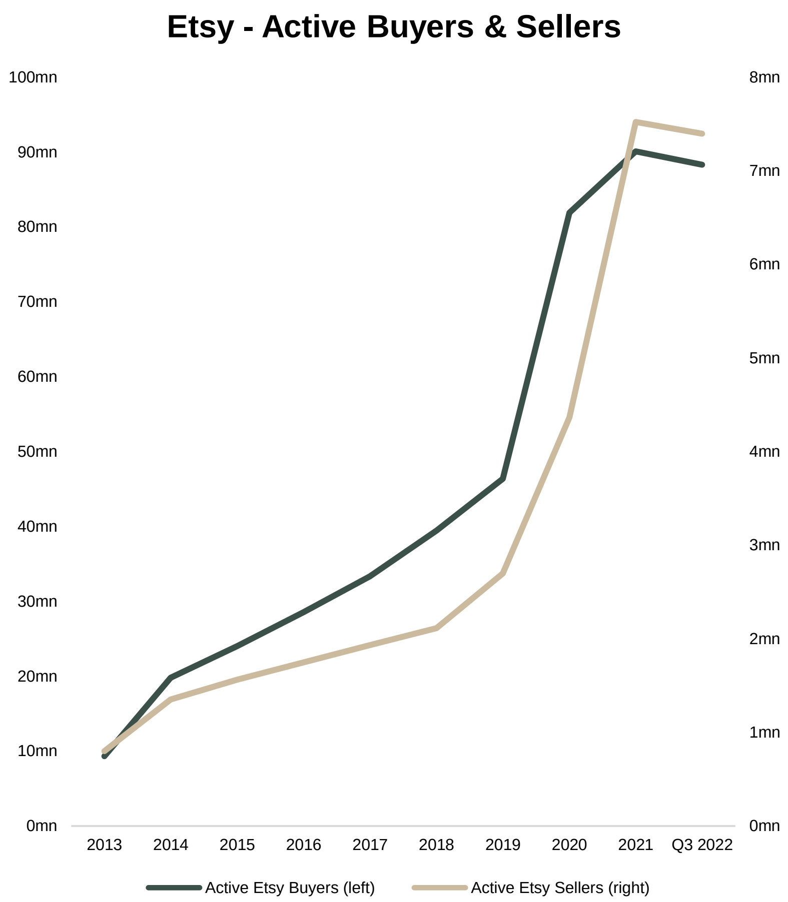
Similarly, buyers on Etsy are not driven by same day delivery or the cheapest price: they want an original product, backed up by Etsy's promise that they will receive what they paid for.

We like investing in businesses where there is no obvious alternative or competitor. Etsy's value proposition to both buyers and sellers means that the experience is entirely differentiated from alternative platforms. Truth be told, the real competitors for Etsy are local farmers' and craft markets, where sellers can offer unique, one-of-a-kind products to would-be buyers. While nominally a competing channel, these markets are in many instances complementary to Etsy: sellers will refer buyers to their online store for a broader range of products, hoping to drive repeat purchases.

As we outlined in Part One, the COVID-19 pandemic turbo-charged the trend of retail moving online. Traditional brick-and-mortar retailers (Walmart, Woolworths, etc.) accelerated their ecommerce strategies in order to be able to meet the demand from customers who were unable or reluctant to journey to their stores.

Etsy was no exception to this trend, with active buyers (defined as buyers who made two or more purchases on Etsy in the preceding 12 months) more than doubling from 47mn pre-COVID to more than 95mn at the peak of the pandemic in 2021.

Illustrative of the network effect in action, the number of sellers on Etsy grew from 2.7mn pre-COVID to 7.4mn sellers in Etsy's most recently reported financial results.



While many COVID-era businesses saw their activity levels revert to pre-pandemic levels as the world reopened, Etsy is unique in that more than 90% of buyers who shopped on the platform during the pandemic have continued to do so.

The pandemic ultimately proved to be a windfall for Etsy, introducing the platform to millions of new buyers and sellers, who now return due to both the user experience and the uniqueness of the product offering.

We have found very few businesses that have experienced an immense step-up in activity due to COVID that have a) been able to hold onto almost all of their pandemic-era gains, whilst b) enhancing the user experience without having to expend significantly more shareholder capital in the process. In our opinion, Etsy makes it onto a very short list.

Capital Misallocation

We place a high degree of emphasis on the capital allocation ability of the management teams that we entrust with your capital. Given the detailed process we follow when we assess this particular managerial ability, we shall leave an in-depth discussion to its own white paper at a later stage. On this particular metric, we would argue that Etsy management have in fact scored poorly.

As part of a well telegraphed strategy to become a multiplatform ecommerce conglomerate, Etsy acquired Depop in July 2021. One can think of Depop as the Etsy for vintage and second-hand (or, in management's words, "pre-loved") clothing. We concluded at the time that while we believed the acquisition was within management's circle of competence, the price paid for Depop (at USD1.63bn, it equated to 23x sales at the time of the acquisition) left little room for error. This was not the first time Etsy had ventured into M&A, having previously acquired Elo7 (the 'Etsy of Brazil') and Reverb (another two-sided marketplace, but focused on new and used musical instruments). Depop was however the largest acquisition to date, and therefore required additional scrutiny.

As has been well documented, 2022 saw the commencement of rapid interest rate rises across both developed and emerging markets. With the benefit of hindsight, the acquisition was poorly timed, as higher discount rates meant that the value of Depop was far less than what management paid for it. This has subsequently resulted in the impairment of *all* the goodwill paid for in the Depop acquisition, meaning that it is unlikely to ever earn an attractive return on shareholders' capital. Management have acknowledged this fact, and we believe it is unlikely that Etsy will undertake further M&A in the foreseeable future.

To be clear, we believe that management's *operating* ability to extend Etsy's marketing, platform development and engineering expertise to grow Depop into the pre-eminent two-sided marketplace for vintage and second-hand fashion remains unaffected. Keeping their eyes on the prize of building a burgeoning Etsy platform is paramount.

Having built a stake in Etsy post the Depop acquisition, we were under no illusion that the price paid implied the potential of a misallocation of capital. While a negative outcome scenario did not invalidate the broader investment thesis for Etsy, we are disappointed when thinking 'what might have been'. Said differently, the capital expended to buy Depop could have been retained and invested in the core business, or put to better use in buying back shares during 2022. Etsy have begun to deploy excess cash generated into share buybacks, which we believe is a much more sensible approach to capital allocation at this juncture.

Ultimately, we are in the business of taking prudent risk in order to generate returns on your capital. We therefore do not seek to avoid all semblance of risk. Instead, we work to ensure that the risks we *do* assume are both uncorrelated and sized appropriately. In the case of Etsy, management's capital misallocation on the Depop acquisition has not jeopardised the Etsy platform nor the business as a whole. Through appropriate sizing, it has also not been overly punitive to portfolio returns, detracting only ~0.67% from our absolute return.

Conclusion

We believe Etsy is a very good example of a capital-light business, which will deliver higher returns on capital over time, to the benefit or shareholders. Internally, we have referred to it (only half-jokingly) as 'all the parts of Amazon's online retail business we'd like to buy if they ever spun it off'.

Etsy does not hold inventory on behalf of its sellers, nor does it get involved in the physical delivery of orders. Etsy merely provides a platform and related services to facilitate exchange. This is very different to the likes of Amazon and (more recently) Shopify, who have chosen to support sellers by offering some degree of fulfilment and distribution capabilities. These capabilities require significant investment in physical assets (warehouses, containers, trucks, airplanes, etc.).

Investments in physical assets can widen the moat and increase the stickiness of both customers and sellers to a platform. However, we believe the fact that Etsy targets such a differentiated set of products – the long tail of unique items, in contrast to the sea of homogenised goods for sale on Amazon – provides it with a sufficiently wide moat that it does not need to invest in fulfilment. In fact, many Etsy sellers sell through Shopify, Amazon and other channels, and concurrently use their backend infrastructure to fulfil orders on Etsy. The key factor to monitor is that sellers continue to prioritise Etsy as their preferred channel, as there are more than 90mn potential buyers that have self-selected as specifically looking for handmade goods.

Much of the market's focus is very short term in nature, where surprises to expectations drive outsized price moves. Our edge lies in identifying and understanding what information we can glean from quarterly reporting that will most directly speak to the long-term inputs of value. In this regard, whether Etsy reports an active buyer number of 90.5mm or 91mm is less important to us than whether the number of habitual buyers (defined by Etsy as buyers who shop more than six times per year on the platform) is growing.

The real driver of returns for long-term investors will lie in converting a greater percentage of the roughly 90mn existing active buyers into habitual buyers (which currently amount to only 8mn). The positive operational gearing that can be delivered in this manner will be extremely significant, in our opinion.

Whether Etsy management can achieve a meaningfully higher habitual buyer cohort remains to be seen. We believe that the strategy of establishing the Etsy brand as the first destination that comes to mind when a buyer is looking for a unique or handmade item is the correct approach to drive repeat purchases.

While the timing on progress may be somewhat uncertain, we are prepared to be patient. In our assessment of this opportunity, we do not believe success is currently discounted in the share price.

Part Four: Outlook & Conclusion

by Etienne Vlok, Daniel Gerdis and Andrew Strasser

We are always mindful of making forecasts. In our experience, most forecasts merely extrapolate the *status quo* into the future. Given the many crosscurrents at play in markets right now, we are even more circumspect this time around.

With that said, we are only 10 months into the current interest rate hiking cycle. Any number of risks that have quietly built up after a decade-plus of free money could suddenly surface due to capital having a cost again. This could take many forms: somewhere an interest payment is missed; lack of liquidity leads to a default on a bond; debt covenants are breached, and lenders call in the outstanding balance of a loan; speculative collateral proves to be worthless. Whatever the cause, the tide of easy liquidity going out is likely to cause more problems in the year ahead as capital misallocation is uncovered.

Unfortunately, many investors (in some cases, institutions with fixed or growing liabilities) invested in asset classes that would ordinarily command much higher risk premia in an environment where interest rates were more reflective of the risks being assumed.

We have long considered certain such assets as purely speculative and transitory. The best example is the boom in cryptocurrencies and non-fungible tokens (NFTs) seen over the past few years. Their spectacular unwind over the preceding twelve months has come as no surprise to us. We are reminded of a story that famed investor Seth Klarman told in *Margin of Safety*, his early-90’s book on successful value investing:

> *There is an old story about a market craze in sardine trading, when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, “Mister, you don’t understand. These are not ‘eating sardines’; these are ‘trading sardines’.”*

This past cycle has been characterized by a sustained period where financial innovation has outpaced capital investment in productive assets. Put simply, we believe more money has gone into pursuing wealth-creation through trading in speculative financial assets than via real investment in productive capacity. We believe the world is yet to experience the full repercussions of accommodative monetary policies that forced investors to take risks that they would normally be uncomfortable with. Unfortunately, many structural excesses that have been allowed to build up over the previous decade remain.

We therefore consider it extremely unlikely that the cost of capital will be going back to zero anytime soon. Investors relying on central banks coming to the rescue with rate cuts to support markets at the first sign of trouble will be disappointed, in our opinion. Accordingly, we think that investment strategies that only worked in a world of rates declining to zero (or below, in some markets) will not work for the foreseeable future.

All of this is happening at the same time as the tailwinds that supported global growth over the preceding 30 years – political liberalisation, free-market economic reform, and globalisation – are dissipating. In their place, investors shall have to deal with unfavourable demographic trends, and – against a backdrop of greater geopolitical rivalry – a push to create more resilient, diversified and secure supply chains. These factors in combination lead us to believe that realised inflation over the next decade will likely be structurally higher than the benign levels experienced over the post-GFC/pre-COVID (i.e., 2009 –2019) period, even when the current inflationary period has been dealt with.

Part of our responsibility in stewarding your capital is to distinguish between transient and structural trends. One change we see as structural is increasing bifurcation of global economic activity into US- and Chinese-aligned blocs, where investors are no longer rewarded for assuming geopolitical risk to the extent they have been in the past.

We believe that the lack of investment in productive capacity over the past decade, in combination with an increasingly bifurcated global economy, will create opportunities. In our view, there is pent-up demand for investment in the industrial economy, unfortunately turbo-charged by the increasing distrust amongst nations following the war in Ukraine and rising Chinese aggression towards Taiwan.

We believe that the businesses owned in the Fund today are well-placed to avoid the transient medium-term risks discussed above, as well as being able to take advantage of the structural changes that we see ahead. The quality of the companies in the Fund today are as good as they have ever been, and the past year has seen valuations become more reasonable.

In summation: we do not optimise the Fund for any specific scenario or macro-economic outcome. We try to ensure that the businesses we own could weather a range of possible outcomes. Thus, whether 2023 sees the world tip into recession (or narrowly avoid doing so) is less relevant to our way of investing. In our opinion, it is far better to focus on the factors creating fundamental value over time, than trying to time markets in 2023.

Conclusion

Thinking of interest rates as 'the price of time' is a very helpful way to understand why this economic cycle is ending in a painful bear market.

In a world of 0% interest rates, time has no price: $1000 received ten years from now is worth the same as $1000 received today, since the interest rate by which the 10-year distant cash flow is discounted to the present (zero) means there is mathematically no difference in value. In such a world, owning a portfolio of speculative assets made a sort of upside-down sense (if not much common sense): over time, assets that 'proved out' would offset the losses of the names that went to zero.

In a world where capital again has a cost, this kind of payoff profile is exceedingly unattractive, and assets that traded at very elevated *prices* due to low rates may find their intrinsic *value* is much, much lower. As financial historian Edward Chancellor writes in his recent book *The Price of Time: The Real Story of Interest*:

> *By placing too low a discount on the future earnings of companies, investors ended up paying too much. […] As the market analyst Max Winkler memorably described: "The imagination of our investing public was greatly heightened by the discovery of a new phrase: 'discounting the future'. However, a careful examination of quotations of many issues revealed that not only the future, but even the hereafter, was being discounted."*

Bear markets are not much fun to experience, but we would argue they serve an important purpose. Clearing out the worst excesses of the previous cycle and the resulting misallocation of capital is healthy, as it lays the foundations of a more stable economic expansion to come.

Despite the challenges of 2022 and the expected headwinds of 2023, we see better days ahead. This is the kind of environment where leveraged investors are forced to sell their crown jewels for cents on the dollar: high quality businesses can become mispriced alongside speculative stocks that never had any durability to their business model.

Our job remains unchanged: to prudently allocate your hard-earned capital to trustworthy management teams at an attractive price, and then to let them get on with creating value by rationally allocating capital.

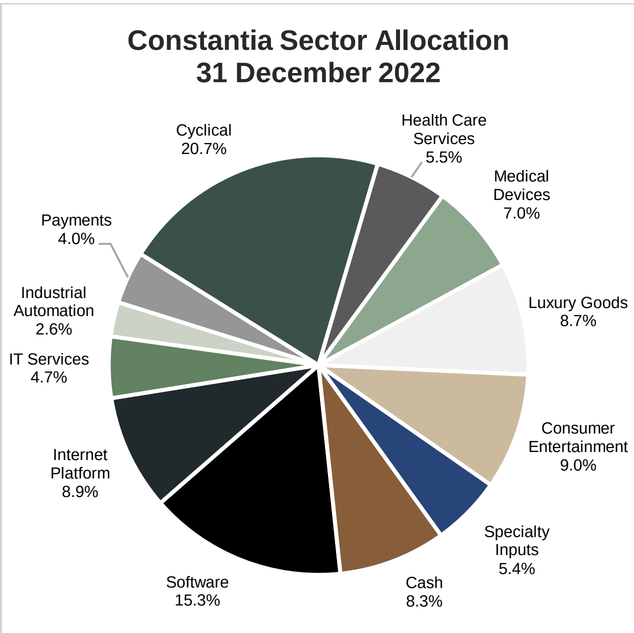
We take heart and look to the horizon. For stock pickers and patient investors, opportunity abounds.

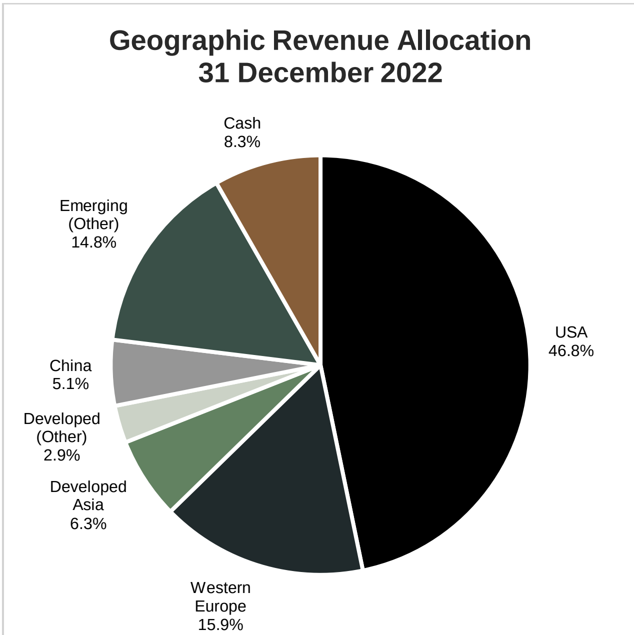
ADDENDUM

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	Dec. 2022
Profitability				
Gross Margin	55.7%	49.8%	52.3%	48.1%
Operating Margin	23.5%	20.1%	24.3%	22.8%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%
Returns on Capital				
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%
Leverage				
Debt/Equity	87.2%	68.6%	78.3%	57.9%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%
Valuation				
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.8%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	4.4%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	5.0%
Holdings				
Number of positions	19	21	21	24
Active Share	86.5%	87.8%	89.0%	89.7%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
accenture	IT Services
Berkshire Hathaway Inc.	US Cyclical
Constellation Software Inc.	Software
HEICO	US Cyclical
LVMH Moët Hennessy • Louis Vuitton	Luxury Goods
Microsoft	Software
	Luxury Goods
Nintendo®	Consumer Entertainment
Thermo Fisher Scientific	Medical Devices
UnitedHealth Group®	Healthcare Services