Quarterly Note

3rd Quarter 2023

Dear Partners,

For the quarter ended September 2023, the AIM Global High Conviction Fund delivered an absolute return (after all fees) of -0.1%. We estimate that AUD weakness added roughly +2.3% to our absolute return over the quarter.

Since sending out our Interim Letter in August – in which we discussed our views on the current macroeconomic backdrop – not much has fundamentally changed. To us, it seems the only real difference is the fact that markets seem to finally be taking the Federal Reserve at their word when they talk about leaving rates 'higher for longer' – a view we have held since late 2022.

This quarterly note provides a breakdown of performance, a summary of changes made in the Fund since 30 June 2023, and our usual quality scorecard in Annexure A. We also include a one-page summary of our investment philosophy in Annexure B.

We believe that we would generally only add to the unhelpful level of noise by providing real-time commentary on what is driving markets 'in the moment'. We prefer to stand back and see if we can discern more fundamental truths that could have a lasting impact on the investing landscape.

The main section of this quarterly note is focused on one such trend: the end of the free money era and the resulting impact this could have on the types of businesses that will create value over the next decade. You'll find it on page three, in *Water or Diamonds?*

Performance to 30 September 2023

	GHCF	Benchmark
Financial Year 2024	-0.1%	-0.4%
2023 (Calendar YTD)	+15.7%	+16.7%
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	+54.0%	+48.6%
Annualized Since Strategy Inception	+11.2%	+10.2%

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. The benchmark is a representative index of global equities listed in developed markets and is denominated in AUD, with dividends (net of withholding taxes) reinvested. Refer to our PDS for more detail.

Portfolio Update

There have been no material changes to the holdings of the Fund since 30 June – we still own the same 21 businesses.

We have increased our position in names with greater valuation support and attractive fundamental prospects (Watsco, AMETEK, TerraVest and Northrop Grumman). These increases were funded from businesses where we believe valuations are more demanding (Microsoft, Accenture, and Fastenal).

Constellation Software – Rights Issue and Debenture

During the quarter, Constellation Software announced a rights issue to fund an acquisitive growth opportunity, giving shareholders the right to purchase an inflation-linked debenture.

Without getting into the technical details of how the debenture is structured, we assessed the terms as favourable, and elected to follow our rights in the Fund. Thus, at quarter end, the Fund owns a modest weight in an inflation-hedged debenture from a high-quality issuer we know well.

For reporting purposes, we will include this debenture in the ‘Cash & Equivalents’ category, as we regard it as easily liquidated (should the need arise) and providing a yield-enhancement over cash in an AUD bank account with the Fund’s custodian.

Conclusion

The most significant event that we see as having a potential impact on the trajectory of interest rates, inflation, business and consumer confidence occurred post quarter-end: the military incursion by Hamas into Israel. A prolonged oil-price shock could lead to stickier inflation and provide a further drag on economic momentum.

From a geopolitical standpoint, we expect far-reaching implications, as many of the principal actors have implicit or explicit support from rival superpower blocs. We see this as accelerating the bifurcation of the global economic landscape – a topic for a future note.

For now, we can only express our deepest sympathy with all affected by this tragedy.

As always, we are grateful for your vote of confidence in Constantia and thank you for your ongoing support. Please get in touch if you have any questions.

Kind regards,

Etienne, Les, Dan & Andrew

Water or Diamonds?
by Daniel Gerdis

Which is worth more: water or diamonds? While many readers may instinctively assume that diamonds are undoubtedly more valuable, we think the answer is a bit more nuanced, largely depending on the context in which one finds oneself.

The Paradox of Value

Famed Scottish economist Adam Smith's 'Paradox of Value' (sometimes referred to as the Diamond-Water Paradox) emphasizes the importance of context in differentiating between an item's intrinsic worth – its value in *use* – and its market worth, or value in *exchange*.

Source: DALL-E

This is best illustrated by way of example: if one were stranded in a desolate desert, the most pressing need would most assuredly be survival. In such stark circumstances, the intrinsic utility of water would eclipse any conceivable monetary worth ascribed to the rarest of diamonds.

While water is essential to life, in most contexts it is relegated to the status of a commodity, with little value outside of survival. In contrast, diamonds have very little value in *use* but have a great deal of purchasing power (i.e., value in *exchange*). The key takeaway from the Diamond-Water Paradox is that context is vital when determining value.

Diamonds, Diamonds Everywhere

Global interest rates have been close to zero for an extended period until the beginning of 2022. Before the current hiking cycle commenced, the world was awash with cheap liquidity. Towards the end of this era of low interest rates, many governments added to the bonanza by handing out stimulus checks to counteract the economic impact of the COVID-19 pandemic, effectively providing free money directly to consumers.

During this period, asset prices were often determined by what the next buyer was willing to pay, largely irrespective of the asset's intrinsic qualities. Whether it was NFTs (recall those paintings of bored apes floating around the internet?), the meteoric rise of the SPAC boom, or any one of the deluge of novelty cryptocurrencies promoted as 'the next big thing', the focus was less on an asset's utility and more on the price that could be fetched from the next willing buyer. Even the equity market was not immune: vanishingly few high-profile IPOs from the 2020/2021 cohort are trading above their offering price, and the less said about the stunning flameout of most SPACs, the better. As of 30 September 2023, the S&P US SPAC Index was still a whopping 43.1% below its February 2021 peak in USD terms.

This was not an environment where anyone was rewarded for paying close attention to value in *use*; instead, the focus was on the profit that could be realised by selling at a higher price. Said differently, focusing on the value in *exchange* was the easiest pathway to outsized gains in an environment of near-zero interest rates.

A New Approach for a New Cycle

In our opinion, the interest rate hikes initiated by the Federal Reserve in early 2022 signalled the end of price exuberance for many assets whose value had been based solely on their potential resale price. We believe that today's investment cycle requires a different approach than simply polishing a stone (or worse…) to sell as a diamond.

Additionally, government fiscal spending – particularly in the US – has reprioritised away from stimulus checks to consumers towards tax breaks and incentives aimed at revitalizing domestic manufacturing capacity.

This reindustrialisation of the US is not only long overdue, but is creating investment opportunities for businesses which possess strong 'value in use'-characteristics.

Let us return to Adam Smith: in this new era of higher interest rates, we believe an investment's ability to generate cash flow – its value in use – will likely be the primary determinant of its market price. To our thinking, it is essential to understand what one owns, and how to assess its utility. Owning a share of a business means having conviction that the good or service they offer will remain essential to the prosperity (or in certain cases survival) of their customers.

One such example currently owned in the Fund is the electronic instrument producer AMETEK. Among many other items, AMETEK manufactures airplane fuel gauges to enable pilots to have reliable in-flight data. We think most readers would agree that knowing how much fuel is left mid-flight has value in use akin to finding water in a desert: it is vital for survival. Another example from a business owned in the fund is Teqnion, who – through a subsidiary company – provides electrical surge protection systems and switchboards for buildings and homes in Sweden. The value in use of their services is very much mission-critical to their end-customer.

If – as we believe – we are in a world where asset prices are more likely to be determined by an asset's value in use rather than relying on finding the next gullible buyer (also known as the Greater Fool Theory of Investment: you can always make a profit, as long as you find a greater fool to sell to), investment gains as a business-owner will lie in how much cash flow that business can generate, and how it is utilised by management. Thoughtfully choosing between returning capital to shareholders in the form of dividends or accelerating the underlying growth of the business through reinvestment, will be a key determinant of investor returns.

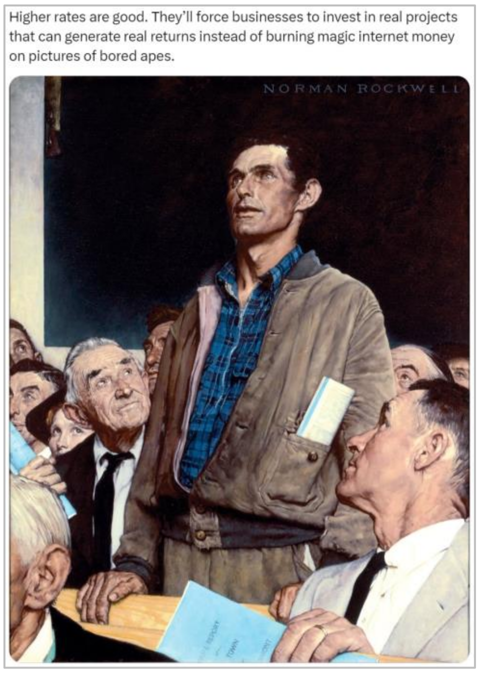
An Unpopular Opinion

In 1941, renowned US painter Norman Rockwell put brush to canvas to create a series of four paintings, each depicting one of the four fundamental freedoms outlined by President Franklin D. Roosevelt as universal to all people: the freedom of speech, the freedom of worship, the freedom from want, and the freedom from fear.

Rockwell's paintings have largely disappeared from the public consciousness, but his *Freedom of Speech* has recently experienced a resurgence in popularity online. Depicting a working-class man standing up at a town hall meeting to voice an unpopular opinion, the artwork is now used as shorthand for speaking an unpleasant truth to the consensus.

We might be in the minority, but our somewhat unpopular opinion is that higher interest rates are not the end of the world. In fact, interest rates around 5% to 6% are not even particularly high in absolute or historical terms; they are merely high when compared to the almost 15 years of near-zero interest rates society has recently experienced.

We recently saw this sentiment expressed on social media using Rockwell's famous *Freedom of Speech* painting. We don't think we could add much to the adjacent visual and caption.



Source: Ramp Capital (@RampCapitalLLC) on X.

Conclusion

While not diminishing the cost of higher rates on individuals and families, the reality is that interest rates at zero distorted the functioning of capital markets. Using a 0% discount rate means there is no difference between $1000 received today and $1000 received in ten years, and thus speculation was encouraged. In that sense, interest rates are a bit like financial gravity – they ground investment in something real.

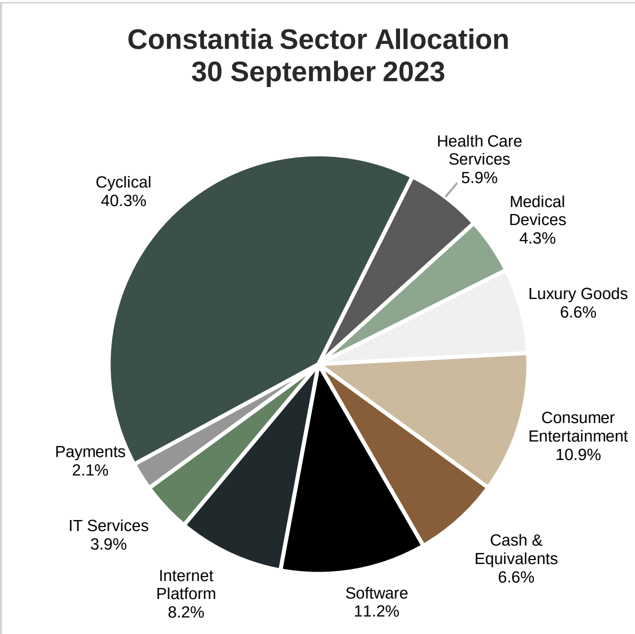
The one thing that has not changed from the past investment cycle is the (increasingly) short-term focus of the market, which by its nature lends itself to 'value in exchange'-type investments. We believe this ultimately provides mispricing opportunities for the 'value in use' investments we seek: affording us the 'right price' to partner with exceptional management teams running exceptional businesses.

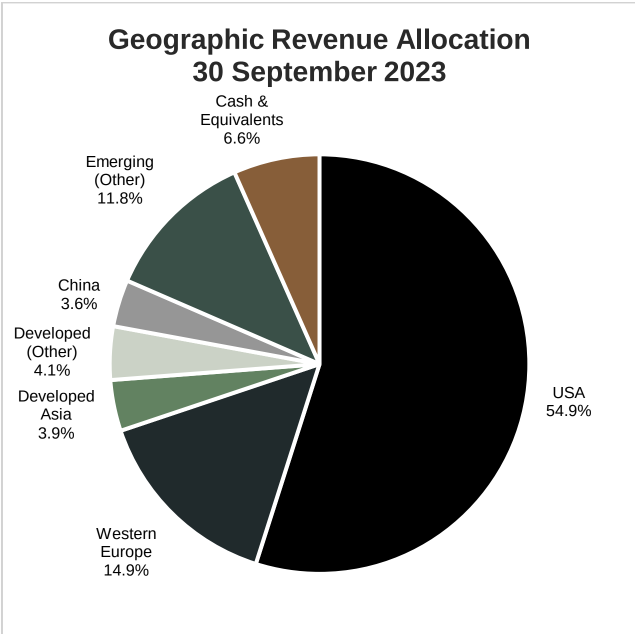
ANNEXURE A: FUND METRICS

Quality Scorecard

Portfolio Characteristic	2019	2020	2021	2022	Sept. 2023
Profitability					
Gross Margin	55.7%	49.8%	52.3%	48.1%	42.9%
Operating Margin	23.5%	20.1%	24.3%	22.8%	19.8%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%	15.0%
Returns on Capital					
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%	12.9%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%	27.2%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%	22.0%
Leverage					
Debt/Equity	87.2%	68.6%	78.3%	57.9%	72.4%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%	37.6%
Valuation					
Free Cash Flow (FCF) Yield	2.8%	3.2%	2.8%	3.8%	4.0%
12m Forward FCF Yield	3.3%	3.6%	3.2%	4.4%	4.3%
24m Forward FCF Yield	3.8%	4.0%	3.6%	5.0%	4.8%
Holdings					
Number of positions	19	21	21	24	21
Active Share	86.5%	87.8%	89.0%	89.7%	88.8%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	Sector
Alphabet	Internet Platform
AMETEK	Cyclical
Berkshire Hathaway Inc.	Cyclical
Constellation Software Inc.	Software
Games Workshop	Consumer Entertainment
HEICO	Cyclical
Nintendo	Consumer Entertainment
Northrop Grumman	Cyclical
Thermo Fisher Scientific	Medical Devices
UnitedHealth Group	Healthcare Services

ANNEXURE B: OUR INVESTMENT PHILOSOPHY

We are ‘business-first’ rather than ‘security-first’ investors, and see ourselves as part owners of the businesses we invest in. Because we subscribe to a business ownership mindset, the quality of the businesses we own matter a great deal to us.

Our investment philosophy can succinctly be summarised as follows:

‘Exceptional businesses, run by exceptional people, purchased at the right price.’

We define the three key terms as follows:

Exceptional Businesses:

- offer a product or service that is hard to disrupt;
- have strong competitive advantages;
- are highly and sustainably profitable;
- convert the majority of their accounting earnings into cash;
- generate more cash than they need to meet the day-to-day needs of operations;
- have a long runway of opportunities to reinvest the excess cash generated;
- have low debt levels to mitigate the risk of failure.

Exceptional People:

- think and behave like owners;
- are appropriately aligned with minority shareholders through share ownership and fair incentives;
- display a degree of trusteeship or moral responsibility to their shareholders;
- have a demonstrable history of value-creating capital allocation.

We look to buy businesses that meet these criteria at prices where we believe we can meet – or exceed – our long-term return targets of 8%- 12% through a cycle.

We do not seek to generate returns by constantly having to trade in and out of businesses. Instead, we believe our long-term return will reflect the fundamentals of the businesses we own. As a result, we tend to own businesses for long periods of time – generally, between three and five years.

We manage a concentrated portfolio and own between 15 and 25 businesses at any given point.

We are bottom-up, fundamental investors. While we are cognisant of macro-economic risks, we do not construct the Fund to take advantage of such events.

We are an equity fund and intend to be between 90% and 100% invested in this asset class. We operate under the belief that if you entrust us with your capital, you want it managed in line with the process and philosophy we follow; you do not expect us to make an asset allocation decision.

We believe in time in the market, rather than timing the market.

We do not engage in shorting, nor do we use leverage to enhance our returns.

Our investable universe is global, and we are agnostic when it comes to market capitalisation size.