Constantia Investment Partners

Annual Letter

2023

Dear Partners

For the calendar year ended 31 December 2023, the AIM Global High Conviction Fund (GHCF) delivered a net return of +22.7%. This brings our cumulative net return since strategy inception to 63.4%, translating to an annual net return of 12.0% per year.

Performance to 31 December 2023

	GHCF	Benchmark
Financial Year to Date 2024	+6.0%	+4.9%
2023	+22.7%	+23.0%
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	+63.4%	+56.6%
Annualised Since Strategy Inception	+12.0%	+10.9%

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.

2023 was a strange year in markets. The prevailing mood at the end of 2022 was decidedly downbeat, and countless market participants were waiting for 'something to break' due to higher interest rates. While warning against simply extrapolating the existing situation at the end of 2022, even **we** got in on the act, writing in our 2022 Annual Letter:

> *[…] the tide of easy liquidity going out is likely to cause more problems in the year ahead as capital misallocation is uncovered.*

The failure of several US regional banks in March 2023 seemed to comprehensively tick this box… and yet, the real economy simply shrugged it off. US inflation has fallen, unemployment has remained low, and corporates have seen decent – if slowing – growth. At present, the talk is of the Federal Reserve cutting rates multiple times in 2024.

We also wrote this in our 2022 Annual Letter (and thankfully, stuck to it!):

> *We do not optimise the Fund for any specific scenario or macro-economic outcome. [Instead], we try to ensure that the businesses we own could weather a range of possible outcomes. […] In our opinion, it is far better to focus on the factors creating fundamental value over time, than trying to time markets in 2023.*

As it turns out, two reasonably certain ways to have earned a sub-par return in 2023 involved getting the timing wrong on 1) being either 'in' or 'out' of the market, or 2) switching between such abstract labels as 'growth', 'value', 'defensives' or 'cyclicals' in an attempt to front-run changes in sentiment.

Looking ahead to 2024, partners will know by now that macroeconomic predictions do not form the basis of our process. We don't think we would be any more accurate this year than in 2023. In this regard, our approach remains 'prepare, don't predict'.

2023: The Year of AI (and Not Much Else)

No retrospective of 2023 would be complete without mentioning the amazing rally in the stocks of many 2021-winners-turned-2022-losers sparked by the introduction of generative artificial intelligence (AI) models such as ChatGPT, which captured the public imagination. In particular, the Magnificent 7 (hereafter, M7) stocks of Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta and Tesla all handily outperformed the market, and contributed roughly +10.1% to the market return of +23.0%. (Said differently, excluding these seven names would have seen markets up +12.9% rather than +23.0%).

While tempting to say that our -0.3% of underperformance relative to the benchmark in 2023 was exclusively attributable to not owning *all* the M7 stocks – which constitutes a fair chunk of many indices these days, given their size – that would be misleading on our behalf. We also had two names that disappointed relative to our expectations for the underlying businesses (meaning the mistake was ours, not the market's). In addition, what would be seen as 'sensible diversification' in a more volatile year became a drag on relative performance in such a strong year. Specifically, our health care exposure (an average weight of ~10.8% of the Fund) simply went nowhere in 2023, and our average cash balance (around ~6.6% of the Fund) also weighed on our relative performance.

We discuss the above in greater detail in Part One of our letter.

Risk is A Four-Letter Word

This brings us to a subject that is central to successful long-term compounding but is rarely discussed: risk.

We understand discussions about risk are (in the words of a former colleague) 'where fun goes to die'. We *also* understand that our industry is set up to emphasise the stuff that make investors feel happy – returns – and rarely gets into the weeds about the risk assumed in the pursuit of said returns. We understand why: it is human nature to highlight the positives whilst downplaying the negatives. However, when it comes to investing, risk and return are inextricably linked, and we believe this fact deserves more scrutiny. Avoiding the topic of risk as 'too academic to address' is intellectual laziness: as an industry, we believe we must strive to explain risk in a more accessible manner.

It is our observation that most people intuitively have a firm grasp of what we would call 'real-world' risk. Consider a hypothetical scenario: a stranger approaches you with an opportunity to instantly double your money. There is one condition to participate: you must put 100% of your wealth behind the prospect. Given the stakes – your entire net worth – any rational person would immediately ask about the nature and risks of the opportunity. Upon being told the 'opportunity' is merely a lottery with low odds of winning, we'd expect the average person to walk away instead of agreeing to what is an almost certain way to being left penniless.

While this specific scenario is obviously ridiculous, we see equivalent bets being offered (and accepted!) in the market all the time – and in many cases, the acceptance is done unwittingly.

Part Two of our letter explains how *we* see risk, and seeks to provide partners with a practical (i.e., non-academic) understanding of the risks we take and avoid when managing the Fund.

Our Annual Letter

As of our 2023 Interim Letter, we are voluntarily disclosing *all* Fund holdings to investors every six months. We also briefly discuss the underlying business performance of each of our holdings over the most recent twelve-month period for which their results are available as of writing. Our investment approach equates to long-term business ownership rather than short-term stock-rental, and therefore our discussions are not the 'stock stories' common to our industry.

Our goal is to provide a warts-and-all perspective, thereby enabling investors to – in the words of Peter Lynch – 'know what they own, and to know why they own it'.

Structure

This Letter is divided into several 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 titles below to jump directly to the relevant part of the letter.

- In Part One, we discuss the drivers of performance for the calendar year.
- In Part Two, we discuss our approach to assuming and managing risk when allocating your investment.
- There are three **annexures** at the back of the letter:
    - Annexure A contains a snapshot of all holdings as on 31 December 2023, as well as detail on their fundamental business performance for the most recently reported twelve-month period.
    - Annexure B contains our usual quality scorecard (including historical metrics for comparison over time), internal sector allocation and geographic revenue exposure breakdowns.
    - Annexure C is a one-page summary of our investment philosophy.

In Closing

One of our investors recently made a very astute observation: when applying our criteria for a 'quality' business, it appears that fund management does not pass the test! The industry has intense competition, low barriers to entry, very little pricing power, and revenues are to some extent dependent on markets, which can be turned upside-down by factors outside our control. 'Why', this investor asked, 'would you choose to own a fund manager?'

We could drone on about loving markets, being fascinated by the intellectual pursuit of investing, and how we enjoy learning about new businesses and industries – all of which is true. Still, one doesn't need to have the white-knuckle experience that comes with *ownership* to pursue these things: simply taking a job at a fund manager accomplishes the same thing. So, why do it this way?

As cliché as it may sound, we see Constantia as our life's work. Admittedly, this is a very abstract concept, but we recently came across a definition by US investor Patrick O'Shaughnessy that we quite like:

Life's work: a lifelong journey to build something for others that expresses who you are.

Legendary US investor Phil Fisher strongly argued for limiting investment to businesses where management have a 'highly developed sense of trusteeship and moral responsibility' towards their investors. We cannot overstate how strongly we share this view, both when it comes to managing the Fund and Constantia as a business.

Trusteeship extends beyond mere compliance with regulations. To us, it is about owning a business where partners trust us enough to feel that we all sit on the same side of the table, and will do well together for many years ahead. We think the only way to pursue this outcome is through having skin in the game as independent owner-managers.

With all these lofty ideals in mind, our work of building this trust will never be done – nor would we wish it to be. We'd all happily do this for the rest of our careers. Being trusted to manage someone else's wealth is a huge privilege and responsibility, and we are extremely grateful to all our partners for your faith in us.

Kind regards,

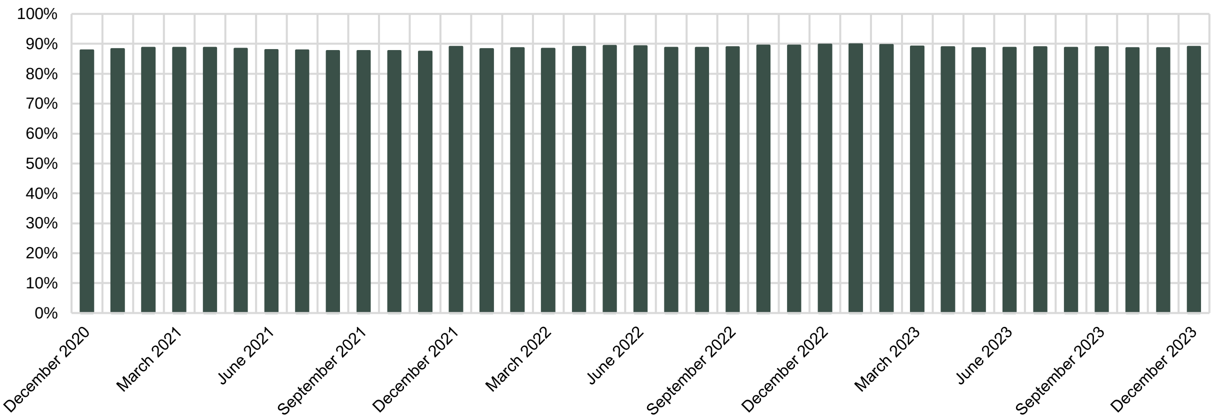
Etienne, Les, Dan & Andrew

Part One: CY23 in Review

by Etienne Vlok & Daniel Gerdis

While it should hardly come as a surprise, we believe in active management: that a considered selection of high-quality businesses will deliver a better outcome than simply owning the entire market over time.

One way of measuring how 'active' we are – that is, how much our holdings differ from the market – is a measure called **active share**. A portfolio that fully copies the benchmark would have an active share of 0%, whereas a portfolio that has absolutely nothing in common with the benchmark would have an active share of 100%. We have maintained an active share well above 80% since strategy inception. (In fact, over the last three years, it has never been below 87%, as you can see from the graph below.)



Given that the Fund had an average active share of 89% in 2023, partners might rightly wonder how on earth we managed to deliver a return (+22.7%) that essentially mirrored that of the market (+23.0%)? We believe there are three factors worth highlighting.

#1: Our Health Care and Cash Allocations

In 2023, our average health care weighting was ~10.8% of the Fund. Two businesses make up this allocation: US health insurer UnitedHealth Group and medical equipment provider Thermo Fisher Scientific. Neither business experienced any deterioration of their long-term fundamentals, in our opinion. The share prices of these businesses simply did not keep pace with the market, and having nearly 11% of the Fund tread water goes some way to explaining our relative performance.

The same is true of our average cash weight of ~6.6% of the Fund.

In years where markets are driven higher by a very narrow set of businesses related to an in-favour sector, region or thematic, diversification is costly on a relative basis. However, we manage the Fund to never be a one-way bet on any trend or thematic and will continue to do so in future.

#2: PayPal and Etsy

PayPal (-13.8% in AUD) and Etsy (-10.6% in AUD) were our two biggest detractors in 2023, costing the Fund a combined -0.67% in absolute performance. While not calamitous to our overall result, it did contribute to marginally lagging the market.

While their short-term *financial* results disappointed, we would argue that the real disappointment for both these positions were due to their underlying businesses not being as high-quality as we believed when we purchased a position in them.

- The payments space has become extremely competitive over the past few years, and PayPal's dominant position as a trusted online wallet has been challenged by the ease of use offered by rival payment options (particularly those of Apple and Google). In short, we overestimated the strength of the moat, and did not fully appreciate how rapidly the competitive landscape had shifted. Instead, we focused on the relatively 'cheap' valuation, and held on too long as a result. Poor management execution did not help matters.
- After seeing a step-change higher in active buyers on their platform in 2020 and 2021, Etsy has spent the better part of the last two years consolidating these gains. However, we sold our Etsy position after becoming concerned about the soundness of management's capital allocation process – prior to them impairing both acquisitions made during the pandemic years. Subsequent to our sale, Chinese-based online marketplaces Temu and Shein started to spend aggressively on online advertising to rapidly acquire a user-base for their platforms, almost certainly to the point of losing money on most individual transactions. While Etsy's management have (rationally) chosen to sit out this race-to-the-bottom approach and focus on the return on investment for each advertising dollar spent, it does mean that Etsy's new user growth – and therefore revenue growth – has materially disappointed. In effect, we overestimated the strength of Etsy's network effect and the loyalty of their customers for 'hand-made' goods. Turns out, people just wanted cheaper stuff!

#3: The Magnificent Seven (M7)

Any attempt to answer the question above would be incomplete if we did not mention the concentrated nature of the broader market rally in 2023, where the M7 (Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta and Tesla) group of stocks contributed +10.1% of the overall market return of +23.0%. To put that into perspective, it means that the other ~1,470 names that make up the global benchmark *collectively* contributed only +12.9%.

To be clear, we owned Microsoft, Amazon, and Alphabet in the Fund, and thus we benefitted handsomely from their performance in 2023. In fact, we have owned these three businesses on an uninterrupted basis from strategy inception in August 2019, due in part to our long-held belief that their cloud businesses would be the 'pick and shovel'-plays of the coming decade of digital transformation. We are not Johnny-come-lately's to these businesses because of the AI thematic that has dominated markets over the past twelve months.

Our point is simply this: in a year where the market bid up virtually every stock sprinkled with the fairy-dust of 'AI beneficiary', the valuations of these businesses have become much more demanding at the start of 2024. In fact, these seven names currently make up roughly 19% of the benchmark index. Today, going 'passive' with a global index-tracking ETF is very much taking an *active* bet on the future of all seven of these names.

Given their natural competitive advantages, there is every possibility that they continue to deliver the goods on a fundamental level. However, unless the market is significantly underestimating their outlook, any rational analysis must conclude that the forward-looking returns for these businesses are unlikely to be as strong as the past few years given the more elevated starting valuation.

By way of example, consider Microsoft. In December 2013, the stock was trading for 11.1x operating cash flow; by the end of 2023, this same measure is 27.4x. While Microsoft has compounded its operating cash flow per share at 15.1% per year over the past decade, multiple expansion of 9.4% per year was a material driver of Microsoft's stunning return over this period (26.0% per year, excluding dividends).

Microsoft hasn't become a bad business – far from it. However, in comparison to the *twin* engines that drove returns for shareholders over the past decade – strong underlying growth *and* a low starting valuation – the next few years will likely have to rely on underlying growth alone, since the multiple expansion is unlikely to repeat (and might conceivably compress).

As always, we focus on business quality, management alignment, and our expectations of forward returns. In any given year, there is going to be some trend or thematic that will trounce the overall market. We do not actively seek to participate in the 'next hot thing', whatever that may be. If the market assigns increasingly exorbitant valuations to these businesses for their 'AI-ness' (for lack of a better term), we will act rationally – particularly when we can see better opportunities elsewhere.

If by choosing not to own the flavour-of-the-month thematic leads to the Fund lagging the overall market in the short-term, we do not view that as investment risk. We discuss our thinking on why this is the appropriate way to behave as long-term stewards of your capital in great detail in Part Two of this letter, which we invite all partners to read.

Contributors & Detractors in CY23

Contributors

Given the impact of the three M7 names we own (Microsoft, Alphabet and Amazon), we have elected to disclose the top eight contributors to our performance for CY23 (vs. our normal practice of disclosing the top five).

	Top Contributors	
Business	**Total Return (AUD)**	**Contribution**
Constellation Software Inc.	+62.3%	+3.9%
Microsoft Corp.	+57.2%	+2.7%
Alphabet, Inc.	+57.9%	+2.3%
Amazon.com, Inc.	+79.8%	+2.2%
Teqnion AB	+84.5%	+1.7%
Nintendo Co., Ltd.	+28.4%	+1.4%
Fastenal Co.	+40.4%	+1.4%
HEICO Corp.	+18.3%	+1.3%

Detractors

The top five detractors to our performance for CY 23 are shown in the table below.

Right off the bat, it is worth noting that none of these names detracted materially from our absolute return: their negative impact ranges from -0.37% to -0.01%, for a combined impact of -0.93%.

	Top Detractors	
Business	**Total Return (AUD)**	**Contribution**
PayPal Holdings, Inc.	-13.8%	-0.37%
Etsy, Inc.	-10.6%	-0.30%
Thermo Fisher Scientific Inc.	-4.0%	-0.15%
Nike, Inc.	-6.6%	-0.10%
UnitedHealth Group Inc.	-0.1%	-0.01%

Positions Purchased & Sold: June to December 2023

The discussion of new purchases and positions sold is reserved for Constantia investors.

Our letter continues on the next page.

Growth in Intrinsic Value

We adopt a business ownership mindset when it comes to investing, and place significant emphasis on measuring the growth of the **intrinsic value** of our businesses over time.

In an investing context, intrinsic value refers to the estimate of value derived from the underlying fundamentals of a business. Generally, this is taken to mean the present dollar value of all the cash a business will return to its owners from now until the day it is wound up.

The measure of how much cash a business could return to its owners is called 'free cash flow', so called because it is the money the business is 'free' to distribute to owners (as dividends or through share buybacks) after investing to a) maintain its competitive position and b) grow in future.

Because management can materially alter our ownership interest in a business by issuing or repurchasing shares, we believe the best way to measure the growth in intrinsic value for our businesses is by measuring the percentage change in free cash flow per share from period to period. Simplistically, this can be calculated by adding the year-over-year percentage change in free cash flow to the year-over-year change in the share count.

Internally, our core focus is on owning businesses able to grow their free cash flow per share (and therefore their intrinsic value) at 12% or better over time.

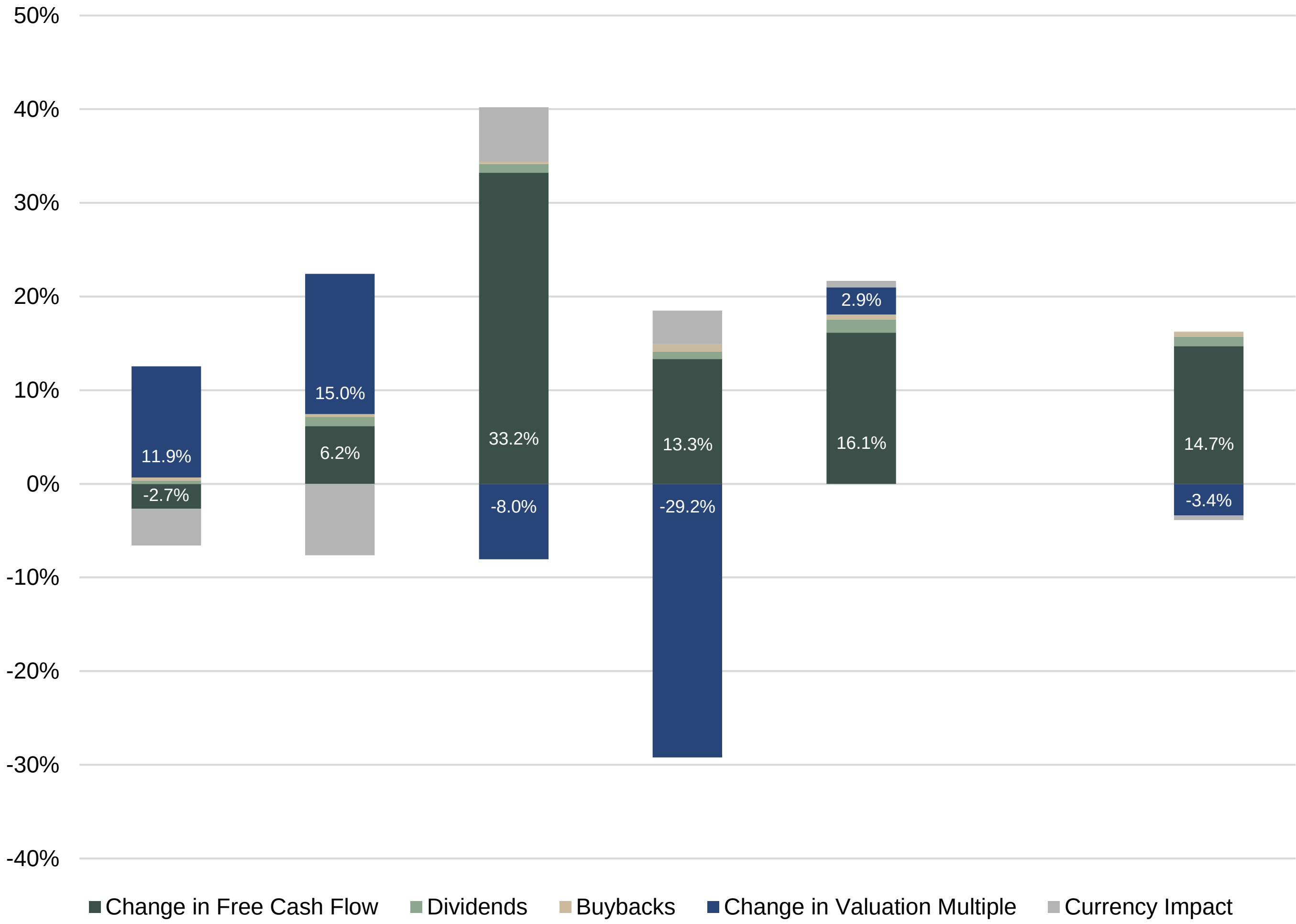
Our Net Total Return Breakdown

The chart on the following page breaks down our net-of-fees total return since strategy inception (August 2019) into the underlying drivers of return for our investors:

- The year-over-year change in free cash flow.
- The cash returned to investors, either in the form of dividends or through share buybacks
- The change in the valuation multiple the market assigns to a business at the time of initial purchase relative to the time of measurement (or eventual sale).
- The impact of currency fluctuations, given that we invest globally but report in AUD.

Though we derive the change in intrinsic value from observable inputs, we should stress that – as with any calculation of intrinsic value – it is at best an imperfect estimate. However, we believe it is directionally correct and grounded in sound economics, and in the decidedly unscientific world of capital markets, we'd rather be roughly right than precisely wrong any day of the week.

2019	2020	2021	2022	2023	Strategy Inception p.a.
+5.3%	**+14.2%**	**+31.1%**	**-15.6%**	**+22.7%**	**+12.0%**



Figures at the top show net total return of GHCF for each period. 2019 and strategy inception are measured from 31 August 2019. Past performance is not indicative of future performance.

- The dark blue bar – representing the valuation multiple the market is willing to pay for a dollar of free cash flow – has been the most volatile component of our returns over time. This makes intuitive sense, as markets are prone to volatility over short periods. In 2023, we estimate that the change in valuation multiple added a very modest +2.9% to our absolute return.
- The dark green bar – representing the change in intrinsic value as measured by the growth in free cash flow from period to period – has been less volatile. In 2023, our businesses grew their free cash flow by +16.1%. The 2023 figure is marginally flattered by a few businesses experiencing a meaningful release of working capital investments made during the highly inflationary environment of 2022. Regardless, the underlying trend of free cash flow growth remains well above 12%, which is what we target.
- Dividends (light green) and buybacks (light brown) have been modest but consistent positive contributors over time. In 2023, dividends contributed +1.4% and share buybacks +0.5% to our total return. The dividend yield in 2023 was slightly higher than our historical average of 1%, largely due to special dividends received from Fastenal and Games Workshop.
- The impact of currency (grey) has been volatile from year to year but tends to even out over time. In 2023, currency was a +0.7% tailwind to our returns.
- In 2023, we estimate that our businesses grew in **intrinsic value** by <u>+16.6%</u> (16.1% growth in free cash flow + 0.5% reduction in share count).

We believe that the rightmost column – breaking down our 12.0% per year net total return since strategy inception – is likely the most interesting feature of the chart, since it looks through short-term volatility.

We estimate that our businesses have grown their free cash flow by +14.7% per year, whilst multiple compression has been a -3.4% per year headwind. Dividends (+1.0% per year) and share buybacks (+0.5% per year) have been steady contributors, whilst the currency impact – despite being volatile in any given year – has only detracted -0.5% per year.

The estimated growth in **intrinsic value** since strategy inception has been +15.2% per year (14.7% growth in free cash flow per year + 0.5% reduction in share count per year).

Over the long term, we believe the return we deliver to you will roughly reflect the growth in intrinsic value of our underlying businesses. Indeed, it would be fair to say this belief is foundational to our entire investment philosophy. As such, we plan to update this chart and present it to you in every Interim and Annual Letter we write in future, enabling you to track the fundamental change in value of the businesses we own.

Part Two: Risky Business
by Etienne Vlok

'Risk': a word which means vastly different things to different people. At one extreme, there are those comfortable investing in a cryptocurrency hedge fund with no track record, no disclosed process, and no external verification of returns, and – in one such case – an actor hired to pose as the CEO to front the whole show; at the other end of the spectrum, there are people worried about buying a pop-up book about giraffes for a toddler.

To avoid burying the proverbial punchline at the back, here's our definition of investment risk:

An investment decision which leads to a permanent and irrecoverable loss of capital.

Why is our focus on avoiding an absolute loss of capital rather than beating the index in twelve-monthly increments? In short, because the math is very much against compounding your wealth over the long-term if you suffer a permanent loss.

To illustrate, consider a $100 investment that suffers a 10% drawdown, leaving it trading for $90. To get back to your original $100, a 10% rally is insufficient, as it only gets you back to $99. Instead, an 11.1% rebound is required.

As the drawdown becomes more pronounced, the math becomes increasingly onerous to recover the initial investment:

Initial Investment	Drawdown	Value after Drawdown	Rally Required to Break Even
$100	-10%	$90	11%
$100	-20%	$80	25%
$100	-33%	$66	50%
$100	-50%	$50	100%
$100	-75%	$25	300%
$100	-80%	$20	400%
$100	-99%	$1	9900%

Mathematically, a key principle of successfully growing wealth over the long term is to minimise substantial drawdowns. While it is always more pleasant to think about all the potential positive returns an investment can earn, we would argue that any approach which is not cognizant of the potential downside is missing the forest for the trees.

Rule #1: Never Lose Money. Rule #2: Never Forget Rule #1.

Because our industry is so heavily focused on relative performance, many people consider 'risk' to be relative: that is, to underperform a benchmark index. In our opinion, framing investment performance in an index-relative context tends to do more harm than good from a behavioural perspective, because it promotes the insidious idea that 'owning the market' is a risk-free way to invest. In combination with the 'fear of missing out'-culture that has developed in markets – most likely because of almost 14 years of zero interest rates, in our opinion – there is a heady mix of dangerous behavioural traps lying in wait for market participants who 'chase' relative performance in the short-term. We have written as much on several previous occasions, but most recently in our November 2023 monthly note:

> *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 number 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).*

> *Using the index as a starting point to reason out portfolio construction can lead to many mistakes, as far as we can see. These include a) needing to have an opinion on everything inside the index, regardless of its attractiveness as a long-term investment or one's own circle of competence in analysing it; b) an unwillingness to look outside of the index (where better opportunities may be available) for fear of appearing 'off-benchmark'; and c) over-diversification.*

We believe the absolute risk embedded in the index is currently rather pronounced. After a decade of easy gains in technology businesses – briefly interrupted by a harrowing drawdown in 2022 – the index is anything but risk-free. It is very concentrated in a few sectors and themes, with many stocks highly correlated to each other as they suck up more and more passive investor dollars. The AI thematic is the prime example of this phenomenon at present.

Some of the research that has crossed our desk of late seems to forget that investing in emerging businesses at the edge of a new technological paradigm is a risky exercise. The enthusiasm with which we have been told to 'just buy something' in the AI space reminds us of a quote from the inimitable Sir Humprey Appleby (portrayed by the late Sir Nigel Hawthorne) in the classic 1980s' British TV series *Yes, Minister*:

1. We must do something.
2. This is something.
3. Therefore, we must do it.

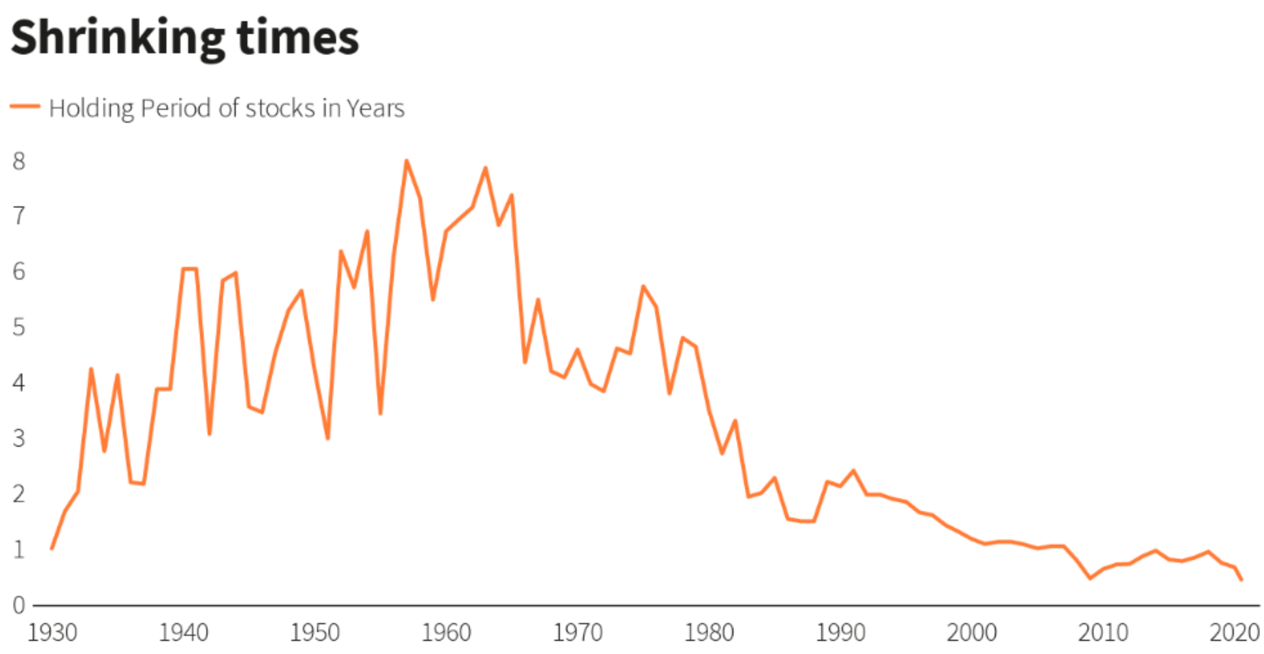
To be clear, we are not modern-day Luddites opposed to technological development or their benefits. We simply know that it is very possible to be right on the big picture ('AI will transform our economies') and still lose money hand over fist by investing in the perceived winners of today if the competitive forces shaping the industry turns it into a race to the bottom. As evidence, we'd cite the steep losses suffered by investors in decades past, when the must-own stories of the day were railroads, cars, airplanes, the personal computer, the first wave of e-commerce businesses, or the mobile phone. In rapidly evolving end-markets, it is virtually impossible to determine with any degree of certainty the competitive state of the industry a few years out, which we believe is vital for successful long-term investing.

Said differently, we think paying top dollar to participate in a nascent industry that does not lend itself to high-conviction forecasts introduces meaningful absolute risk (i.e., risk of permanent loss of capital). By deciding not to participate, we may introduce some relative risk (i.e., underperforming tech-heavy index benchmarks) over the short-term, but we see that as a far lesser evil when stewarding your capital.

'It is difficult to get a man to understand something when his salary depends on his not understanding it.' Upton Sinclair

This approach makes us out of step with the majority of our industry. If anything, it seems to us that the way to 'sell' a fund these days is to pick a few sexy 'themes' and then market the vast returns on offer by simply investing in said themes, with little explanation of how much absolute risk investors are assuming as long as the stocks keep going up. This approach eventually ends up incentivising fund *gathering* over fund *management* and leads to a huge misalignment of incentives between the principals (investors) and their agents (fund managers).

Skewed incentives can lead to a spectacular amount of value destruction, and therefore we always keep an eye out for it. Sadly, our own industry seems rather guilty. Consider the chart below, which tracks the average holding period of stocks over the past several decades.



Note: Holding periods measured by value of stocks divided by turnover
Source: NYSE, Refinitiv

As of 2020, the average length of time a stock is owned is now around five-and-a-half months. Consider the implications of this fact: given that there are still some long-term holders of stocks out in the world (our average holding period is around 4.5 years, and is trending up), to arrive at an average of 5.5 months implies there are a huge numbers of market participants who hold stocks for days at best (or in the case of some algorithmically driven trading strategies, mere seconds).

British economist John Maynard Keynes – writing in his book *The General Theory of Employment, Interest and Money* – correctly predicted this trend as far back as 1935:

> *It might have been supposed that competition between expert professionals […] would correct the vagaries of the [speculator]. It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise. For most of these persons are […] largely concerned, not with making superior long-term forecasts of the probable [return] of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned not with what an investment is really worth to a man who buys it 'for keeps', but with what the market will value it at, under the influence of mass psychology, three months or a year hence.*

It seems to us as if there is no lack of professional market participants willing to jump on the flavour-of-the-month 'investment theme' in order to chase performance or to make sure their marketing approach remains firmly in step with the dominant consensus of the moment. Given the way the incentive structure of our industry is constructed, we are not surprised at this.

Let us pin our colours to the mast: we do not think the current industry structure incentivizes fund managers to think long term and manage for absolute risk. Fund manager bonus pools are generally determined by relative outperformance above a benchmark index over a short time horizon – say, one year. This creates an almost impossible-to-resist incentive for Keynes' 'expert professional' to buy a sector or stock in anticipation that the market will value it higher '*three months or a year hence*' – in effect, to do 'whatever it takes' to beat the market in twelve-month increments. Through this process of chasing *annual* outperformance, fund managers can end up taking far more risk than their investors understand or would want them to take. This dynamic is at the heart of the principal-agent conflict in our industry.

The late Jack Bogle – pioneering founder of The Vanguard Group and creator of the low-cost index fund – commented on this phenomenon at length in a speech given at the University of California in October 2006:

> *[…] what went wrong was a pathological mutation in capitalism – from traditional owners' capitalism, where the rewards of investing went primarily to those who put up the capital and took the risks – to a new and virulent managers' capitalism, where an excessive share of the rewards of capital investment went to corporate managers and financial intermediaries.*
>
> *How could this have happened? There are two principal reasons. First, the 'ownership society' – in which the shares of our corporations were held almost entirely by direct stockholders – was gradually transformed into a new 'agency society,' with financial intermediaries controlling the overwhelming majority of shares. […]*
>
> *The second reason is that the predominant focus of institutional investment strategy turned from long-term investment in the business market to short-term speculation in the expectations market. During the past few decades, we entered the age of expectations investing, where growth in corporate earnings – especially earnings guidance and its achievement – became the watchword.*

Speaking as financial intermediaries and agents ourselves, we strongly agree with Bogle. His larger point is that there is no discernible benefit to the economy (or society at large) from having the ownership of publicly traded companies completely change hands every few months; it is done largely for the benefit of the fund management industry, not for the investor.

There are ways to address this misalignment of incentives, in our opinion. Forcing agents to have meaningful skin in the game – and therefore, experience downside risk alongside their principals – is one way to achieve better outcomes. Another approach we have seen work is to create a structure which emphasises the *consistency* of absolute returns (i.e. can gains be maintained and compounded over time), rather than the *magnitude* of relative returns over the short-term. Clawbacks – another form of sharing downside risk – also has merits, in our view.

While there is no perfect system, we think these types of structures create far more symmetrical outcomes between investors and fund managers.

Conclusion: The Risks We Can Live With

We said at the outset that we would write a non-academic essay on 'real-world risk', explaining how we think about allocating partners' hard-earned wealth. We have ended up with an essay on incentives and behaviour – perhaps not surprisingly, given how we assess investment opportunities.

For the avoidance of doubt, we believe that the 'real-world' risk you run when entrusting us with your wealth is not that we underperform markets by a percent or two over the short term. We believe that real-world risk – the probability of permanent capital loss – mostly resides in one of the following:

1. That we badly misanalyse the management team, culture or moat of a business we have chosen to invest in, causing us to suffer a permanent loss of capital when the business fundamentals materially underperform our expectations or management behaves in a way that hurts our interest as minority owners. We obviously do quite a lot of research to minimise this risk but make no mistake – the quality of *our* decisions will determine if we do well in the long-run.
2. That we succumb to the short-term pressures of our industry and assume more risk than is required of us to generate the steady returns we target, and then buy into businesses with meaningful absolute risk in an effort to bolster our relative return in the short-term.

How do we translate these beliefs into the Fund?

As we have become older – and hopefully wiser – we have come to the conclusion that the great fortunes in the stock market have been generated by businesses led by people who are somewhat out of step with the general ‘Wall Street’ culture of stock markets: they tend to under-promise, they do not play the ‘guidance’ game, they tend to own quite a lot of stock in the business they manage, they do what is right for their business in the long-term, and they act with a sense of trusteeship and moral responsibility to their shareholders. In short, they behave like owners.

Given these observations, is it any surprise that our process increasingly leads us to investing with aligned owner-operators? We believe such businesses fit our ‘profile’ of an investment candidate better than most professionally managed businesses, simply because the people involved have greater incentives to behave well over time. We already own quite a few businesses that fit this mould. Over time, we’ll likely own more.

By finding these types of businesses at attractive valuations, we believe we can meaningfully lower long-term risk for our investors – not the risk of lagging the market in any particular year, but of permanently losing your capital. As an aside, we also think it enhances the forward-looking prospects of the Fund, as these types of individuals are generally better capital allocators than professional managers, in our observation – but that is an essay for another day. (We can almost hear the sigh of relief).

ANNEXURE A: PORTFOLIO BUSINESSES

This section of our letter is reserved for Constantia investors.

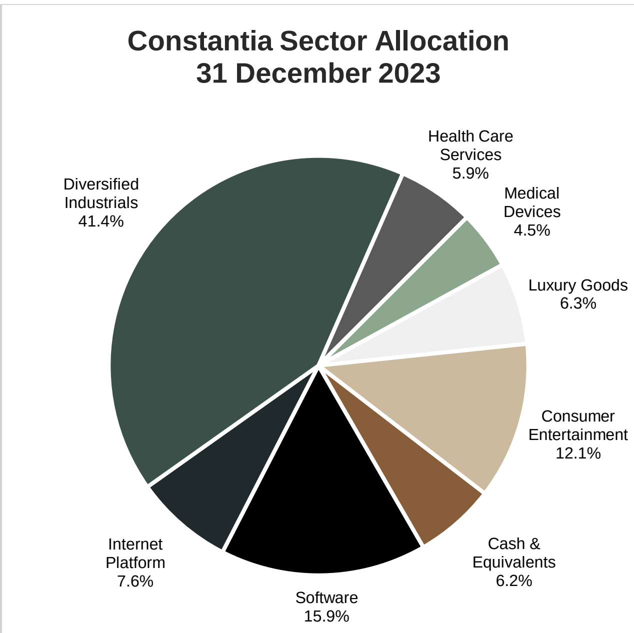
Our letter continues on the next page.

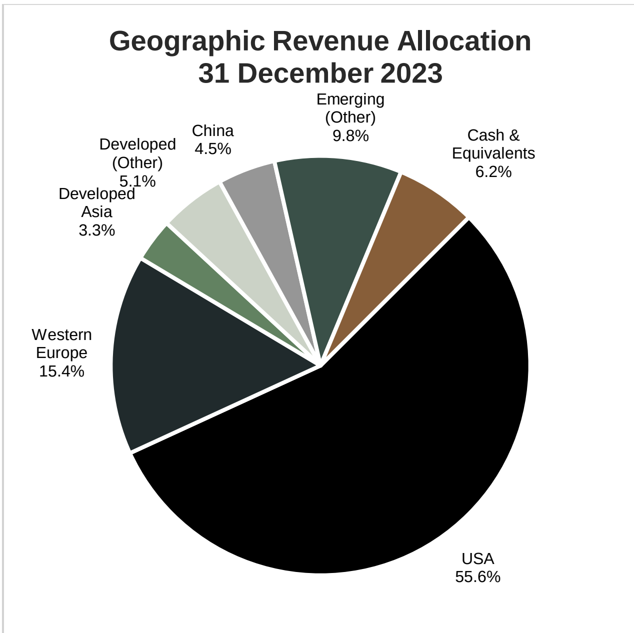
ANNEXURE B: FUND METRICS

Quality Scorecard

Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	Dec. 2022	Dec. 2023
Profitability					
Gross Margin	55.7%	49.8%	52.3%	48.1%	43.3%
Operating Margin	23.5%	20.1%	24.3%	22.8%	21.2%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%	15.7%
Returns on Capital					
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%	13.0%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%	26.0%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%	21.2%
Leverage					
Debt/Equity	87.2%	68.6%	78.3%	57.9%	77.3%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%	47.2%
Valuation					
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.8%	3.7%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	4.4%	3.8%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	5.0%	4.3%
Holdings					
Number of positions	19	21	21	24	21
Active Share	86.5%	87.8%	89.0%	89.7%	89.0%

Internal Sector & Geographic Revenue Allocation





Source: FactSet, Constantia analysis.

ANNEXURE C: 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.

Right Price

We look to buy businesses that meet these criteria at prices where we believe we can meet – or exceed – our long-term return target of between 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, or longer if warranted by fundamentals.

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.