Constantia Investment Partners

Quarterly Note

3rd Quarter 2024

Dear Partners,

For the quarter ending September 2024, the AIM Global High Conviction Fund delivered an absolute return (after all fees) of +4.7% compared to a benchmark return +2.4%. We estimate that AUD strength detracted roughly -1.8% from our absolute return over the period.

To anyone following markets on a daily basis, it was a messy quarter, with the reasonably pleasing top-line result masking quite a bit of below-the-surface churn. The narrative around AI stocks shifted somewhat in July and August, with questions emerging about whether the long-term expectations embedded in the market valuations of some of the perceived winners could possibly be wildly overstated. Against this backdrop, the Fund performed well in both absolute and relative terms over the first two months of the quarter. Subsequently, the US Federal Reserve cutting rates by 0.5% in the middle of September sparked a rotation back to the higher growth, narrative-driven end of the market. As our investors would know, we are generally not positioned in businesses that fall into that definition, and not surprisingly – we lagged modestly in September.

We flag these details not because we think that measuring performance by the month is in *any* way helpful or relevant to our long-term internal objective (after-fee returns of above 12%, with below-market volatility). However, it is somewhat instructive to illustrate the dynamic of our strategy, based on our factual experience of the past five-plus years: lagging the broader market when the focus shifts to macro-economic or thematic narratives, and then doing better when the time comes to be measured on underlying business fundamentals.

Beyond the point made above, we believe that we would 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.

This quarter, we question the wisdom that investors need to 'invest in change', over buying into what is '*Stable In Time'.*

Performance to 30 September 2024

	GHCF	Benchmark
Financial Year 2025	+4.7%	+2.4%
2024 (Calendar YTD)	+12.6%	+16.9%
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	+84.1%	+83.1%
Annualized Since Strategy Inception	**+12.8%**	**+12.6%**

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

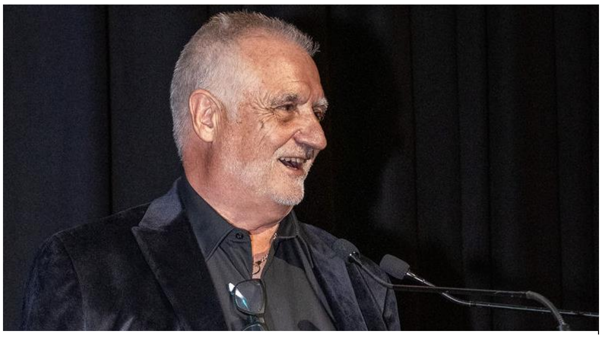
Over the quarter, portfolio activity was very muted. We exited one of our special opportunity investments because 1) we assessed there were core, long-term holdings with more attractive forward returns to which we could re-allocate the capital, and 2) the special opportunity itself had performed in-line with our expectations since our purchase.

No new positions were introduced.

Something To Celebrate

Many of our partners will have interacted over the years with Les – our inimitable chief executive, manager of risk, master of coin, conductor of operations and diligent servant of clients. That may sound like quite a full plate, but the reality is we have consciously designed Constantia to be a straightforward business, and so Les can wear all those hats *and* still find time to play golf on weekends.

Needless to say, we believe Les is very good at what he does – mostly because he cares about doing it well, but also because he's been around for so long that he knows what matters, and how to get it done efficiently.



Les receiving the 2024 'Contribution to the Australian Hedge Fund Industry' award.

What may be less well known is that he is also (in the words of a good friend of the firm) an 'absolutely first-class bloke'. Over his storied career, Les has always been quick to lend an ear (or – frequently – a hand) to anyone in our industry needing advice or a push in the right direction. This help has taken many forms: from being a mentor to countless entrants starting out in our industry, through to sitting down and explaining the ins and outs of some arcane bit of operational knowledge to someone trying to set up a risk management process (or, indeed, a whole new fund manager from scratch).

At the 2024 Australian Alternative Investment Awards – held in the last week of September – Les was (belatedly, in our opinion) recognised for his tireless, decades-long effort to be of service to all who crosses his path with the *Contribution to the Australian Hedge Fund Industry* award – which, we should add, is voted on by peers.

The three of us are extremely lucky to have Les at Constantia (particularly at the time in his life when the siren song of the golf course is justifiably strong!) – and we'd argue that his dedication to providing 'best of breed' service to our clients – all while being a first-class bloke, in every sense of the word – is a great asset to our partners as well.

The award could not have gone to someone more worthy, in our opinion. Congratulations, Les.

Conclusion

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

Stable In Time

by Etienne Vlok

In our time in markets, we have observed that there seems to be a widespread belief that one 'needs to invest in change' to make money. Intuitively, this makes a reasonable amount of sense: there is 'the way the world works today' – with its attendant crop of winners and losers – and there is 'the way the world will work tomorrow'. If one can identify the 'winners of tomorrow' and invest in them today, making money is surely a doddle!

Having run headfirst into this particular wall numerous times over the collective course of our careers, we have a slightly different point of view. Quoting from our 2021 Annual Letter:

> *Investing in the 'new' is – at the best of times – a risky endeavour.*
>
> *The problem with trying to predict the future with any degree of precision is that it is inherently unknowable. Speculating about how the world will change in ten years' time is a fun mental exercise, but to make money from said speculation, a phenomenal number of things have to go right: not only do we need to guess 1) the correct variables (i.e. the things that will change), but then 2) correctly estimate how the variables will change, as well as 3) how the market will react to these changes relative to the previously embedded expectations for the status quo.*
>
> *Frustratingly, one can be right about the general trajectory of technological advancement (the car replacing the horse-drawn buggy, for example), but still lose money hand over fist by trying to invest in the change (cf. investing in automakers for the majority of the 20th century.)*

As Warren Buffett pointed out in 2021, at one stage there were at least 2,000 US automakers, while by the end of the 1990s there were only three left. In short: successfully investing 'in the future' is a tough gig!

Predictions About the Wrong Things

One way that investors can try and get around this issue is by using so-called 'innovation frameworks'. By applying a structured analytical process, can one identify a market that is going to be disrupted or disintermediated, and then invest accordingly?

To briefly explain what we mean, let's imagine we are working for one of the major consulting firms in the mid-1990s, and we are approached by a large-cap, multinational operator of hotels to answer a (seemingly simple) question: 'what does the advent of the internet mean for my business?'

Being somewhat clever and armed with an MBA as well as the above-mentioned frameworks, we could likely have foreseen the rise of online travel booking and the resulting disintermediation of the traditional 'travel agent' channel. We might even have predicted the rise of new, alternative online platforms (such as Booking.com or Expedia) to consolidate the new channels of travel demand. On a practical level, our recommendation to the client might have been to build out their online capability to deal with customers *directly* as more travellers used the internet to make their own reservations, but we would almost certainly have framed 'the internet' as an *opportunity* – not a competitive threat – for big global hotel operators. After all, it's not like the internet is going to lead to a whole slew of new hotels being built to compete with the existing ones, right?

Our advice would have been accurate… for about 10 years, when Airbnb came along and fundamentally *changed* what was meant by 'hotel' and 'holiday accommodation' – a development which *did* disrupt the traditional hotel industry. In our opinion, the problem with innovation frameworks is that they tend to work only in hindsight, and their predictive value is therefore quite limited. To quote the independent British tech analyst (and former venture capital investor) Benedict Evans: 'with fundamental technology change, we don't so much get our predictions wrong as make predictions about the wrong things'.

The More Important Question

The quote below comes from someone generally thought to be quite innovative and forward-thinking: Amazon.com founder Jeff Bezos, speaking at a conference in 2012. (Our emphasis added in bold).

> *I very frequently get the question: 'What's going to change in the next 10 years?' And while that is a very interesting question; it's a very common one. I almost never get the question: 'What's not going to change in the next 10 years?'*
>
> *I submit to you that that second question is actually the more important of the two – because* ***you can build a business strategy around the things that are stable in time****. […] In our retail business, we know that customers want low prices, and I know that's going to be true ten years from now. They want fast delivery; they want vast selection. It's impossible to imagine a future a decade from now where a customer comes up and says, 'Jeff I love Amazon; I just wish the prices were a little higher,' [or] 'I love Amazon; I just wish you'd deliver a little more slowly.'*
>
> *When you have* ***something that you know is true, even over the long term, you can afford to put a lot of energy into it****.*

We have subscribed to this view of the world for some time. To quote again from our 2021 Annual Letter:

> *We think a better question to ask is "what will stay the same for the next ten years?" We believe we can find much better opportunities in businesses that have embedded in their value proposition a natural resilience to technological disruption. […] Looking exclusively for 'what is new?' means you'll end up wasting a lot of effort on businesses that have novelty but ultimately no staying power. [Instead], we look for businesses that are to a large extent protected from fundamental technological disruption, yet still flexible enough to change to meet the developing needs of their customers.*

When we step back and observe much of what passes for market commentary today, a lot of it seems to us to be focused on information that is quite ephemeral – that is, it will be worthless in a quarter or two. Will it matter in three years if stock X misses or beats earnings expectations for the upcoming quarter by 1% if the long-term drivers that lead to the business creating value remain intact? Unless the starting valuation is extremely expensive, almost certainly not.

To paraphrase legendary British investors Nick Sleep and Qais Zakaria, we purposefully seek out information that has a longer shelf life, because it allows us to make predictions and forecasts with a higher degree of confidence and conviction. Using the question of 'which businesses or industries lend themselves to higher conviction forecasting?' as a filter to screen out ideas is a *very* different approach from 'investing in change', but in our experience it underpins the attractive risk-adjusted returns we have been able to deliver. Adopting this filter – essentially, a stubborn refusal to worry about the short-term news flow which drives markets on a daily basis – leads us to ask 'longer shelf life' questions, which we believe has greater predictive ability. Examples include questions about management (their integrity, alignment and capital allocation track record), industry structure (susceptibility to a capital cycle), moat (source and direction) and staff culture – all of which are vital to our interests as equity owners if we intend to be long-term owners of a business.

Conclusion

To be exceedingly clear: partners should **not** think our focus on 'what is not changing' is the same as investing without a keen sense of paranoia about the competitive trajectory of the businesses we *do* own. We have <u>zero</u> interest in owning the last horse-buggy manufacturer. Change is the only constant in capitalism, and we expect our businesses to evolve and develop alongside their underlying markets: Berkshire Hathaway and Amazon in 2024 are most definitely not the same businesses as in 2000. (We plan to discuss this paradox of 'investing in what is not changing' with the need for our businesses to evolve in a future note).

However, for each of our businesses, we like to think that we have identified a **stable** kernel of truth that underpins the persistence of their value creation ability for long periods of time. This may range from a cost-conscious, aligned management team with sound capital allocation principles to structurally advantaged business models, or an appreciation of the fundamental human behaviour that leads to switching cost or brand moats. To paraphrase Bezos, we believe we can **build a portfolio around what is stable in time**.

To no one's surprise, we readily admit that we do not know what will happen in the future. However, we do not think the path to investing success lies in correctly predicting the future on a consistent basis, but rather in positioning ourselves to survive and thrive in multiple possible outcomes. In our opinion, the key to doing this lies not in 'investing in change', but rather in 'investing in what is *not* changing'.

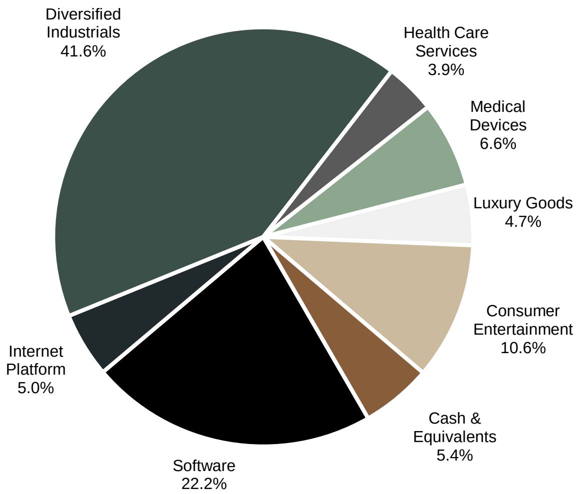
ANNEXURE A: FUND METRICS

Quality Scorecard

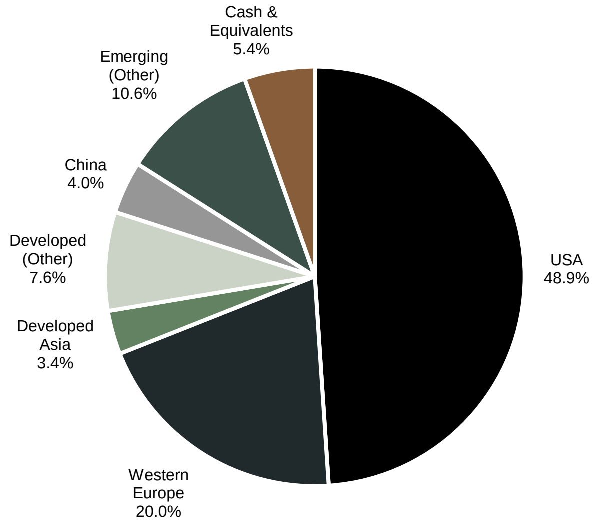
Portfolio Characteristic	Dec. 2019	Dec. 2020	Dec. 2021	Dec. 2022	Dec. 2023	Sept. 2024
Profitability						
Gross Margin	55.7%	49.8%	52.3%	48.1%	43.3%	40.6%
Operating Margin	23.5%	20.1%	24.3%	22.8%	21.2%	19.4%
Free Cash Flow Margin	18.9%	17.0%	17.6%	16.8%	15.7%	16.9%
Returns on Capital						
Return on Assets (ROA)	13.0%	11.9%	13.7%	13.9%	13.0%	11.9%
Return on Equity (ROE)	28.3%	24.9%	30.4%	29.8%	26.0%	23.9%
Return on Invested Capital (ROIC)	24.0%	16.5%	20.7%	19.5%	21.2%	24.9%
Debt Ratios						
Debt/Equity	87.2%	68.6%	78.3%	57.9%	77.3%	70.3%
Net Debt/Equity	19.3%	22.1%	27.3%	8.6%	47.2%	39.4%
Debt/EBITDA	1.5x	1.6x	1.2x	1.4x	1.7x	1.6x
Net Debt/EBITDA	0.4x	-0.2x	0.1x	0.1x	0.9x	0.7x
EBITDA/Interest Expense	46.0x	60.5x	56.3x	59.7x	50.3x	31.7x
Valuation						
Free Cash Flow Yield	2.8%	3.2%	2.8%	3.8%	3.7%	3.5%
12m Forward Free Cash Flow Yield	3.3%	3.6%	3.2%	4.4%	3.8%	3.8%
24m Forward Free Cash Flow Yield	3.8%	4.0%	3.6%	5.0%	4.3%	4.3%
Holdings						
Number of positions	19	21	21	24	21	21
Active Share	86.5%	87.8%	89.0%	89.7%	89.0%	90.4%

Internal Sector & Geographic Revenue Allocation

Constantia Sector Allocation
30 September 2024



Geographic Revenue Allocation
30 September 2024



Source: FactSet, Constantia analysis.

Top Ten Holdings (alphabetical)

Business	End Market
amazon	eCommerce & Cloud Infrastructure
AMETEK	Electrical Components
Constellation Software Inc.	Niche Vertical Market Software
Games Workshop	Niche Hobbyists & IP
HEICO	Aerospace Components
LIFCO	Dental Care & General Industrials
LVMH	High-end Luxury
Nintendo	Video Gaming & IP
Terravest Industries	Heating & Chemical Transport/Storage
watsco	Heating & Air-conditioning

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:

<u>Exceptional Businesses:</u>

- 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.

<u>Exceptional People:</u>

- 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.

<u>Right Price</u>

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.