FORAGER

CHIEF INVESTMENT OFFICER LETTER

QUARTERLY LETTER MARCH 2022

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FORAGER FUNDS PERFORMANCE SUMMARY (as at 31 March 2022. Net of all fees and expenses)

	1 month return	3 month return	6 month return	1 year return	3 year return (p.a.)	5 year return (p.a.)	10 year return (p.a.)	Since inception* (p.a.)
Forager Australian Shares Fund	2.86%	-12.02%	-9.36%	13.14%	11.57%	5.79%	12.99%	11.13%
Forager International Shares Fund	-7.29%	-18.57%	-22.75%	-15.81%	14.65%	9.30%	-	13.09%

Past performance is not indicative of future performance and the value of your investments can rise or fall.
Performance in FASF is calculated using Net Asset Value (NAV), not the market price.

*8 February 2013 for FISF and 30 October 2009 for FASF

A DOSE OF REALITY—THE MEDICINE GROWTH STOCKS NEED

It was a decidedly downbeat mood at this year's Roth Conference in California.

With the sun shining and with meetings scheduled in person for the first time in three years, you might have expected smiles and laughter. But for most CEOs in attendance, a bit of sunshine and socialising did little to offset the declines in their companies' share prices over the past year. After all, it's been a brutal year for many of Roth's clients—typically smaller, rapidly growing companies for whom it's not uncommon to be down 70% or more from their 52-week highs.

When Forager's Gareth Brown asked one business's CEO what he thought about an acquisition that his company made this time last year, he responded, "I paid $200 million for it and the market cap of my entire company is now less than that. How do you think I'm feeling?"

We tried to cheer a few of them up. They might be worth hundreds of millions of dollars less than they thought they were, but at least now we are more interested in their businesses. The 2021 Conference, in comparison, was three long nights for the Forager team, sitting in one Zoom meeting after another talking to interesting companies with absurdly high share prices.

It's not just lower share prices in 2022 that have us feeling more enthusiastic, though. Most CEOs aren't just aware of their share prices—they use them as cues to make decisions. The current environment is bringing a much-needed dose of reality back into that process.

LESS DESTRUCTIVE ACQUISITIONS

Gareth's CEO wasn't the only one to make an overpriced acquisition.

We sold our investment in his company soon after it was announced. But there are others. Inflated market prices for listed companies are often used as justification for value-destructive acquisitions. **Gan**, **Whole Earth Brands** and **Neogames** have been guilty in the International Shares Fund, while **iSelect** is a perfect example in the Australian Shares Fund.

With share prices in the gutter, fewer CEOs are discussing acquisitions at all, and those who are seem far more sensible about the prices they're willing to pay. That can only be a good thing.

LESS PROFLIGATE SPENDING

Rampant investor enthusiasm for these businesses has also created an abundance of cash with which to "accelerate" growth plans. With more money, the theory went, companies could hire more developers, spend more on marketing, and what would have taken 10 years could be achieved in five.

While it's impossible to know what the alternate reality would be, the main acceleration seems to have been in developer wages and customer acquisition costs. That's certainly been true for Forager investments like **Adore Beauty** and **Twitter**. **Google** was doing very well out of all that marketing spend, but newly capital-constrained managers might find that the spend can be throttled without too much diminution in growth.

VALUE WILL BECOME CLEARER

What makes a business good value has changed over time. And if Forager's research and valuation process has taught us anything, it's that we sometimes need to look beyond our own backyard—down Tech Avenue, for example—for new opportunities that hold potential.

Navigating through this unfamiliar territory has made for a bumpy ride. It begs the question: will these loss-making companies ever make a profit—and if so, how much?

I'll set the non-revenue generators to one side for the moment. Bizarrely, the share prices of the likes of **Audio Pixels** haven't fallen as much as their revenue-generating comrades. All the businesses we are looking at have real revenue and the qualities investors were overly excited about 12 months ago remain.

They are growing rapidly thanks to dramatic changes in the way businesses deal with customers, staff and shareholders alike. It is all shifting online and, while COVID-related lockdowns might have brought forward a few years of growth, many of these businesses still have a decade of transition ahead of them. Many do have high levels of recurring revenue and have become deeply entrenched in their clients' businesses. This makes them relatively resilient to economic downturns and more predictable than most—at the revenue line, at least.

However, the big remaining unknown is just how profitable they will ultimately become. We know software businesses in particular can be highly profitable. **Adobe** generates pre-tax profit margins of more than 35%. **Microsoft**, **Alphabet** and **Meta** are all absurdly profitable businesses. Even the ASX's **Hansen Technologies**—which generates operating margins of 25%—shows that lesser-quality software businesses can generate wonderful margins if you decide to run them for cashflow.

But very few software companies are going to mimic Adobe. There's a monstrous valuation difference. So far, most of these smaller companies have shown they can grow the cost line at least as fast as their revenues.

THE YEAR FOR PROOF

Countless companies at the conference said they've been getting the message loud and clear: it's time to show investors some proof that their business can be highly profitable. We heard the same thing time and again through the Australian reporting season, too. From **Whispir** to **Bigtincan** and Adobe copycat **Nitro**, CEOs are telling us that this is the year for proof.

With investors no longer rewarding growth at any cost, most businesses are now focused on showing that they can increase their margins, at the very least reach profitability in the short term, and show investors that they can grow their revenue much faster than their expenses.

We're clearly not going to know what the ultimate profitability will look like for these still-immature businesses. But by the time the 2023 Roth Conference rolls around, we will have a much better idea of which companies are on the right trajectory. And for those that succeed, they may also be much happier about their share prices.

NO REPRIEVE FROM VOLATILITY IN 2022

It's been a crazy few years for financial markets and frankly, even we—generally welcoming of volatility—would not have complained about a year of reprieve.

Russia is one of the largest suppliers of oil and gas, and Russia and Ukraine combined grow almost 30% of the world's exported wheat. Commodity prices have skyrocketed on supply risks and inflationary pressures were concerning even prior to the war's influence on prices. The last thing the western world's debt-burdened economies need is higher interest rates. Neither governments nor consumers can afford dramatic increases in their financing costs. Yet what we want and what we get are often poles apart.

All of this has investors on edge. Stock prices have been extremely volatile, mostly to the downside (with commodities being the exception). And smaller companies have been punished far more than their larger counterparts. After all, larger companies are generally better equipped to navigate difficult environments than small companies.

Forager's relatively concentrated portfolios of mostly small companies have seen substantial share price falls in 2022. The unit price for the Forager International Shares Fund has fallen 19% in the three months to 31 March 2022 and the Australian Fund's distribution-adjusted price has fallen 12% over the same period. While it seems we have swapped some of the 2021 financial year's extraordinarily high returns for volatility this year, we invest in concentrated portfolios of small stocks because of the long-term excess returns that will generate.

The current bout of pessimism for such companies shows exactly why the returns can be so large. Yes, there is plenty to worry about, and we have reduced some exposure to discretionary consumer spending and economically sensitive sectors in both portfolios. But many share price reactions have been extreme and indiscriminate, no matter whose backyard you're looking at.

Economic cycles come and go and good businesses add to their competitive advantages in difficult times. Even businesses that you would expect to be robust against economic changes have experienced share price falls of more than 50%. Many of these companies would be highly attractive investments if interest rates were 6% or more. In short, most investment cases remain intact and lower prices simply make for higher future returns. Again, it's a long-term view.

New Forager investors might find unit price falls disconcerting. My only advice is to welcome them and, if that proves difficult, to not look too often. Because this year is going to be another challenging one for all. But while the risks are meaningful, so are the rewards on offer. Best to let us do the stressing.

Kind regards,

Steven Johnson
Chief Investment Officer