FORAGER

CHIEF INVESTMENT OFFICER LETTER

ANNUAL LETTER JUNE 2022

FORAGER FUNDS PERFORMANCE SUMMARY (as at 30 June 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	-12.30%	-26.50%	-35.33%	-27.91%	3.26%	-1.19%	9.68%	8.24%
Forager International Shares Fund	-5.98%	-13.18%	-29.30%	-38.09%	8.00%	5.79%	-	11.04%

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

HOW TO CAPITALISE ON MARKET TURMOIL

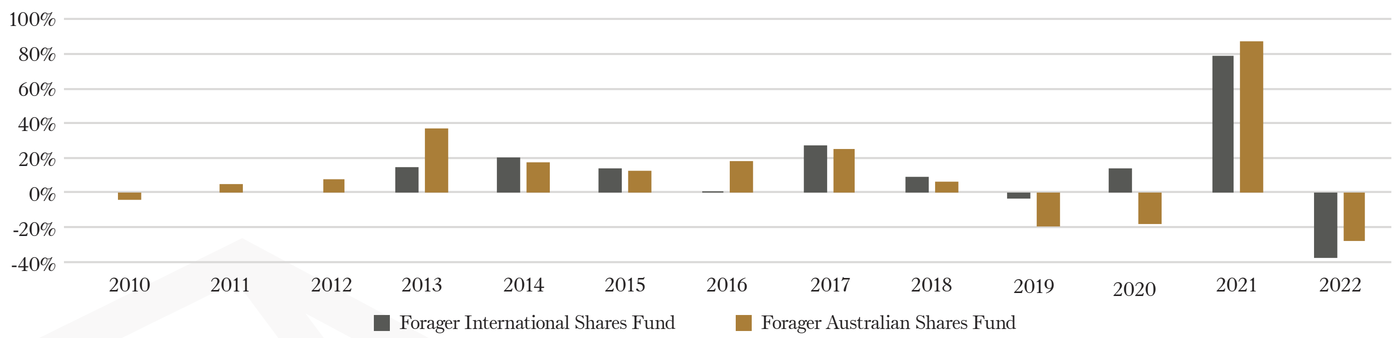
I started Forager Funds Management in the midst of a global financial crisis. The neurotic nature of financial markets has been on show many a time over the ensuing 13 years. From commodity bear markets in 2016—when stocks like **South32** and **Whitehaven Coal** were trading for cents in the dollar—to a 2019-2020 meltdown in value stocks that left businesses like **NZME** available for purchase for just one year's profit, there have been bouts of depression.

At other times and in other parts of the market, the predominant emotion has been euphoria. We've had a decade-long bull market in tech stocks. And undeveloped lithium mines sporting multi-billion dollar valuations.

the worst return we had ever posted was a loss in the Australian Fund of 19.7% in 2019. To be clear, there were some missteps contributing to those performance numbers. In our International Fund, we took baby steps when giant steps were required.

More often than not, investors do too much. Selling those stocks that have done well to buy the latest and greatest new idea always feels appealing. That cost us a lot of money in our Australian Fund, with the new investments over the past 12 months being the most significant contributors to a bad year. Working hard to do nothing is a skill that is very difficult to master.

RELATIVE PERFORMANCE BY FINANCIAL YEAR*



*Including distributions

I've never seen anything like the past two years, though. The swings from pessimism to optimism and back again have been wild. Often with regards to the same stock. Often without that much changing when it comes to an underlying business's prospects.

The past two years have bookended the best and worst years of performance for both of Forager's funds. And not just by a little bit. In the 2021 financial year, the Forager International and Forager Australian shares funds returned 78.9% and 87.1% respectively. Their previous best years were 27.4% and 36.9%. In 2022, the losses were -38.1% and -27.9%, respectively. Prior to 2022,

GIANT STEPS NEEDED

In the International Fund, though, we were guilty of not doing enough. We were aware of and vocal about a bubble in growth stocks. I wrote a CIO letter in our December 2020 Quarterly Report warning about the risks of higher inflation.

We sold half our position in some stocks that were beneficiaries, three-quarters of our stakes in others. We invested 4% of the portfolio in commodities stocks that have performed relatively well. We bought shares in **Tesco** and **Lloyds Bank**, two very cheap stocks that, unlike most, didn't see their share prices pummelled over the past year.

But the returns have still been terrible. The remaining investments in the winners of 2021 tumbled, some more than 70%. The implosion in growth stocks has taken almost every non-mining small company along for the ride, including new investments over the past year that we thought would prove more resilient. Rising interest rates have translated into a significant re-rating (downwards) for some of the fund's high-quality larger companies.

Paraphrasing Warren Buffett, predicting rain doesn't count if you don't build arks as well. Our portfolio changes were meaningful but they needed to be dramatic. Patience is usually a virtue but there are times when urgency is called for. The 2021 financial year was one of them.

Still, that doesn't explain the magnitude of the portfolio moves over the past few years. Forager's portfolios hold far fewer stocks than most and are often heavily skewed towards the smaller end of the market.

That typically makes the returns more volatile than average. But this is unprecedented.

WHY HAS THE MARKET BEEN SO VOLATILE?

I can only posit theories.

There seem to be fewer investors who are even attempting to value businesses. Narrative-based investing has the ascendancy. Buy **Zoom** because everyone is stuck at home on conference calls. Sell Zoom now that everyone is going back to the office. Buy **Tesla** because everyone is going to buy an electric car. Sell Tesla because interest rates are going up.

The actual value of the underlying business rarely rates a mention. This style of investing is not new—most financial bubbles were built on the back of wonderful narratives. But its accessibility is unprecedented. Retail investors can buy any stock anywhere in the world, often without paying an explicit brokerage fee. Thematic index funds have multiplied like a mouse plague, offering stock market punters the ability to prognosticate on everything from cryptocurrency mining to millennial consumers and pot stocks.

Such waves of buying and selling when a particular thematic is in vogue or not are creating dramatic over-reactions in both directions.

VALUATION AN INEXACT SCIENCE

The few of us left who are trying to value businesses are also finding that process more uncertain than usual. That's not to say that valuation is ever an exact science. But three years of unprecedented economic disruption has compounded the problem. Some businesses made small fortunes out of the crisis. Others haven't made a profit for years. Now we are facing a potential recession and a significant rise in short and long-term interest rates. Working out what a business's future earnings might be is more difficult than usual.

Put these two factors together and the share price moves—in both directions—have been more extreme than anything I have seen. Correlations have been extremely high. And individual company performance and results haven't made much difference.

I have some sympathy for investors feeling like they want to crawl into a hole. It's not pleasant being a fund manager, either, in such a volatile environment. One year we're held up as heroes, the next we (apparently) wouldn't know which side our bread is buttered on.

WHY BENJAMIN GRAHAM STILL HAS RELEVANCE

I stumbled across Ben Graham's books in my early twenties. The father of value investing wrote Security Analysis in 1934, which was the first textbook about how to value a business, and then Intelligent Investor in 1949. Much of both books have become redundant. Graham largely focused on the tangible assets a company owned, whereas much of a modern company's value lies in intangible assets like brands and networks.

But his most important lesson has become my most important asset.

A company's share price is simply the last price at which two people transacted a tiny sliver of the company in question. Sometimes it represents a reasonable estimate of the entire value of the company. Sometimes, driven by human emotion, a need for cash, or a view that someone might be able to transact at a more favourable price in the future, the traded price varies dramatically from a company's underlying value.

Yet generally speaking the only time the traded price matters is when you want to buy or sell.

"The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only the extent that it suits his book, and no more. Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment."
– Ben Graham, The Intelligent Investor

The mental anguish in Graham's days was caused by a daily quote in the newspapers. Today, we can look up share prices every second and are bombarded with flashing screens bearing a striking resemblance to a poker machine.

Ignoring those flashing lights has become more challenging than ever. But that only makes it all the more important. Especially in times of heightened volatility, it may pay to remember Graham's words. The price I am seeing on my screen every day—the thing that causes me so much anguish—simply represents the last price at which a transaction took place.

Whether our portfolios are up 80% or down 30%, I stay focused on the true value of the businesses we own. We don't get that right all the time either. But it tends to be a lot less volatile than the share price.

ROADSHOW

Join us at our annual roadshow in the coming weeks. We look forward to getting out and about to see some of you in person, and for those who cannot make it, we invite you to join our virtual roadshow on the 9th of August.

Kind regards,

Steven Johnson
Chief Investment Officer