FORAGER

CHIEF INVESTMENT OFFICER LETTER

QUARTERLY LETTER DECEMBER 2022

FORAGER FUNDS PERFORMANCE SUMMARY (as at 31 December 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	-3.87%	9.36%	16.69%	-24.54%	6.42%	0.07%	9.96%	9.19%
Forager International Shares Fund	-5.13%	2.47%	1.52%	-28.23%	4.48%	5.31%	-	10.62%

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

THE CONSUMER, INFLATION AND SMALL CAPS: THREE BIG "WHAT IFS" FOR 2023

"But" is a dangerous word for investors. I know you can't pick the bottom of markets, Forager investors tell me, but I still don't want to invest until I am "sure" the worst is behind us. I know you can't predict markets, many fund managers say, but here are my prognostications anyway. Most forecasts are wrong, and the ones that are right are usually a result of the inevitable tail actually getting pinned on the donkey through random chance.

That doesn't mean the future isn't worth thinking about. If ever there was a year where macroeconomics mattered, it was 2022.

The S&P 500 index of US stocks had its seventh worst year on record, falling 18%. More unusually, bonds also performed horribly, with 10-year US government bonds suffering double-digit losses for only the second time since the 1920s. That made it one of the worst years on record for a diversified portfolio of stocks and bonds.

That was all thanks to inflation spiralling out of control and central banks around the world rapidly raising interest rates to contain the inflation threat. More specifically, we started 2022 with asset prices that assumed near-zero interest rates forever—an assumption that proved disastrously wrong.

That's the way I like to contemplate the future. Less trying to forecast with certainty. More trying to understand what current asset prices assume, and looking for risks and opportunities should those opportunities be wrong.

Frankly, as you can see in Forager's Fund returns for 2022, we have not turned the contemplation into appropriate portfolio settings. Despite giving some serious thought to Why Inflation Might Return in January of 2020, both portfolios have suffered as interest rates rose throughout 2022.

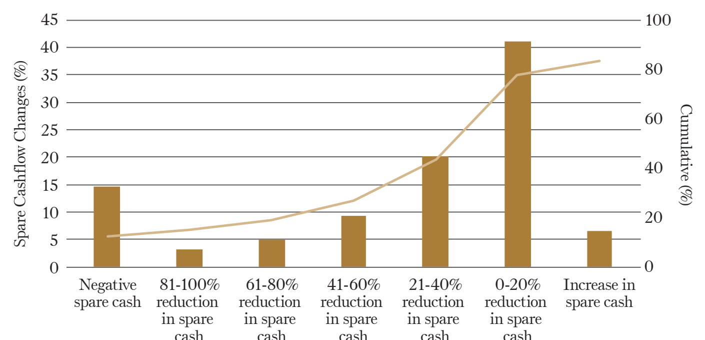
With the aim of doing better this time around, here are some thoughts on the key questions facing investors for 2023.

HOW BAD DOES IT GET FOR THE AUSTRALIAN CONSUMER?

Let's start with the Australian consumer. You don't get any points for pinning the tail on this donkey—2023 is clearly going to be tough. The Reserve Bank of Australia has raised interest rates by 3% since March this year and is expected to add another 0.5-1% to that by March 2023. Thanks to a proliferation of fixed-rate loans, significant amounts of prepayment through the pandemic and a lag for rates to be passed on to borrowers, most of the pain of these rate rises is yet to be felt. It will, though, through 2023 and 2024.

The RBA estimates that some 15% of variable rate mortgage holders do not have enough spare cash flow to absorb the hit. At an aggregate level, Australia's debt service ratio (the percentage of disposable income dedicated to servicing loans) will rise from approximately 13% to 18%, the highest level since 2008. On the flip side, the savings rate has already fallen from almost 20% of income during Covid lockdowns to 7% in September 2022. The day of reckoning can be delayed as those Covid savings get used up, but at some point the Australian consumer needs to curtail their spending.

SPARE CASHFLOW CHANGES FOR VARIABLE RATE OWNER OCCUPIERS



*Cash flow is estimated as income net of mortgage payments and essential living expenses; assumes interest rates rise by 350 basis points relative to April 2022 levels; wages and inflation evolve in line with August 2022 SMP forecasts.

Source: Reserve Bank of Australia

Share prices have fallen a long way for most companies selling to the Australian consumer. For the most part, though, I still look at the expectations and question whether they are low enough. Especially for the beneficiaries of the pandemic. JB Hi-Fi, for example, saw its profit margins (earnings before interest and taxes) jump from an average of 5.3% pre-COVID to 8.6% last financial year, mostly thanks to dramatically higher throughput. It trades at just nine times last year's earnings and is a wonderful business. That nine can become 15 fairly easily, though, as sales and margins contract.

It's a fair price, rather than a bargain. And that's true across most of the discretionary sector. There will (hopefully) come a time when investors are far more pessimistic.

WHAT IF INFLATION FALLS HARD?

Inflation is clearly going to be a big factor again in 2023. Despite the falls of 2022, asset prices today are consistent with interest rates of about 4% in Australia and the US. If they need to rise much further than that (roughly 1% of further increases), there is more downside for both equities and bonds. While it remains a debate with well-founded arguments on both sides, there are good opportunities for investors prepared to take the risk.

The Manheim Used Vehicle Value Index which tracks used car prices - the single most significant contributor to US consumer price inflation over the past year—has now fallen 16% from its peak in January. Oil and gasoline prices are down more than 30% since June, shipping costs have more than halved and lumber prices—after quadrupling through 2021—are now back to historical levels. Moreover, global food prices look like they are about to turn negative, a stark difference from the 20-40% year-on-year rises witnessed through 2021 and the first half of 2022. The price of wheat is now below where it was prior to Russia's invasion of Ukraine.

When the 2022 highs for these items are used as the base for inflation calculations in 2023, they will be meaningful negative contributors and headline inflation numbers will fall dramatically (and possibly be negative).

I, for one, hope zero rates are a thing of the past. It makes my job—finding cheap stocks—nigh on impossible and causes serious distortions in asset prices and misallocation of capital in the real economy.

And this could be a temporary reprieve, of course. Job markets remain extremely tight and wage inflation is a more intransient issue.

But it is worth thinking about a scenario where inflation becomes less of a problem. Maybe it was transient after all, just a much longer transit period than economists first thought. That would allow the RBA to nurse the consumer through a difficult adjustment period with a lot more care. More importantly for our portfolios, the share prices of many growing companies have been smashed on the prospect of higher and higher rates. If there are only a couple more rate rises to come, investor focus should shift to the resilient nature of these companies' revenues through what will be an inevitably difficult economic environment.

WHAT IF 2023 IS A GREAT YEAR FOR SMALL CAPS?

They say you should never ask a barber whether you need a hair cut. Well never ask a person who has a massive portfolio skew to small companies whether small company share prices are going to have a good year.

At least I am on the record making the opposite argument a few years ago. But let me make the argument anyway: what if 2023 is a great year for small caps?

That might seem counterintuitive. Everyone is telling you to buy defensive, resilient businesses, right?

Well, in and of itself, what everyone is telling you is often a good contrarian indicator. But global small-cap fund manager Global Alpha recently released research suggesting there is more to my question than a simple contrarian viewpoint.

First, dramatic underperformance during 2022 has led to starting relative valuations for US small companies that are the lowest since 1992. Here in Australia, the ASX Small Ordinaries Index was down 21% for 2022, versus an All Ordinaries Index that was down just 7%. For non-mining companies, the performance was even worse.

RELATIVE PERFORMANCE OF THE ASX SMALL ORDINARIES INDEX VS ASX ALL ORDINARIES INDEX

Source: Bloomberg

That leaves us with some undemanding valuations. And starting prices matter more than anything else.

Second, small companies tend to perform better in a recession than most investors anticipate. They can be nimble and agile and are often run by a founder or significant shareholder who has a strong incentive to make tough decisions early.

Third, acquisitions become far more attractively priced in an economic downturn and can be far more important for small companies than large ones. That is both for companies that are doing the acquiring and those that get bought. Our Forager Australian Shares Fund received takeover offers for five different companies in the second half of 2022, out of a portfolio of just 30 stocks.

The combination of low expectations embedded in share prices and companies performing much better than anticipated through recessions has, surprisingly, led to small cap outperformance through recessions.

Global Alpha's research was US-centric but showed that, historically, small caps have started outperforming large caps from the time a recession hits, not just once it is over.

In the US, small caps were the best-performing asset class for the five years post the 1973/4 market meltdown, through a recession and a decade of high inflation.

LOWER PRICES EQUAL BETTER RETURNS

It has been a wild start to the 2020s and 2023 can deliver plenty more unexpected twists and turns. My grandmother always tells me the secret to happiness is low expectations, though. The good news is that expectations are a lot lower today than they were just 12 months ago.

Kind regards,

Steven Johnson
Chief Investment Officer

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