FORAGER

CHIEF INVESTMENT OFFICER LETTER

QUARTERLY LETTER MARCH 2023

FORAGER FUNDS PERFORMANCE SUMMARY (as at 31 March 2023. 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	-3.85%	-2.84%	6.26%	-16.66%	28.65%	0.79%	8.47%	8.78%
Forager International Shares Fund	1.57%	10.73%	13.46%	-2.41%	15.37%	7.92%	11.74%	11.46%

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

WHY MONETARY MADNESS NEEDS TO BE BANISHED FOR GOOD

I have to admit to a touch of schadenfreude watching the demise of Silicon Valley Bank (SVB) on Twitter. All of those Silicon Valley free-marketeers screaming at the government to rescue them was a sight to behold.

They are right, though.

Moral hazard is a serious problem in the modern economy. Bailouts and rescues are becoming ubiquitous. Not only does that create a system of heads private investors win, tails the taxpayer loses, it derails creative destruction. Dumb ideas need to fail. Poorly deployed capital needs to be redeployed to businesses and managers that have good ideas.

That's how you get productivity growth in an economy. The fact that we don't let anyone go bust these days has been a significant contributor to productivity growth declining relentlessly for the past 20 years.

For all that, no bank depositor should ever lose their money in a developed-world economy. It is absurd to think every single small and medium-sized business should be analysing bank balance sheets to determine the creditworthiness of their deposits. If you deposit your money in a regulated, licenced, developed-world bank, you have every right to expect that your money will be there as and when you need it.

REGULATED AND CAPITALISED

Before we get onto the solutions, it is worth noting that plenty of investors are losing money despite the government bailout. SVB was listed on the stock exchange. Its $11bn of equity has been wiped out (the market capitalisation was $43bn at the peak). Unsecured lenders to the bank are in for a haircut too. There are far worse examples of moral hazard if you want to find them.

But it was an abject regulatory failure. Back in February, hedge fund manager Bill Martin (@RagingVentures on Twitter) highlighted SVB's insolvency risk using nothing other than the company's latest public financial statements. In 10 tweets, Martin showed how the bank had invested its rapidly growing deposits in long-term fixed-income securities that plummeted in value as interest rates rose. The bank was allowed to account for those investments at much higher values because they were supposedly "held to maturity". When the bank's tech clients started burning through their deposits, however, it was the market value that mattered. At market value, SVB was insolvent.

How can a regulated bank invest almost all its at-call deposits in assets with a duration greater than ten years? How can a regulator let them do that? The simplest, most basic liquidity rules should stop a regulated bank from taking such a stupid risk.

MONETARY MANIPULATION THE ROOT OF MANY PROBLEMS

My best guess is that this won't be a widespread issue in the banking sector. Not many bank treasurers are that stupid. For most banks, including the larger regional banks in the US, valuing their assets at current interest rates will not significantly impact their capital position.

It is emblematic, though, of the stupidity that can happen when interest rates are manipulated to zero. From commercial property to unlisted infrastructure assets to Australia's housing market, trying to rescue an economy through ultra-low rates has consequences that are now becoming obvious to everyone.

Monetary policy is a very blunt, often ineffective tool with wide-ranging unintended repercussions. Yet it has become the primary tool relied upon in times of crisis, despite fiscal policy (government spending) being a far more effective method of targeted stimulation.

Central Bank governors should not be on the homepage of tabloids like the Daily Mail, where Australia's Reserve Bank Governor frequently features as a pantomime villain. The role that positive real interest rates play in efficient capital allocation should be given more weight. And encouraging people to overextend themselves at artificially low rates can cause financial crises.

The collapse of a US regional bank might be a relatively containable issue. It won't be the last disaster caused by the monetary madness of the past few years. If inflation risks start to recede and the economy starts to weaken, I hope these lessons aren't forgotten.

COULD AUSTRALIA'S BANKS FAIL?

There is no stupidity in protecting yourself against seemingly minuscule risks. Especially when protection is free. If you can spread your deposits around multiple Authorised Deposit-taking Institutions (ADIs) and avail yourself of the Australian government's explicit $250,000 deposit guarantee, why not?

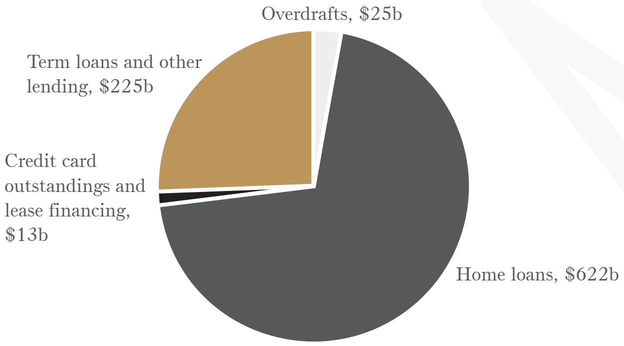
I would also be willing to bet a substantial amount of money that, were an Australian bank to fail, all depositors would be protected. For exactly the reasons outlined above, the government would quickly step in.

That doesn't mean we shouldn't be thinking about the risk. As equity market investors, the consequences for the wider economy and our portfolios would be significant.

So, could an Australian bank fail?

They share one thing in common with SVB - an unhealthy level of exposure to one sector. For Silicon Valley Bank, that was the tech sector. In Australia, it is lending against residential property. Over 70% of CBA's $885bn loan book is home loans.

CBA LOAN PORTFOLIO



Source: CBA 2022 Annual Report

The topic of whether Australia's house prices will ever fall far enough to threaten the viability of one or more of our banks is the subject of conversation at far too many Australian dinner parties. The simple fact is, it is a risk. A bank with a healthy spread of loan types is safer than one with all its eggs in one basket.

As for the specifics of the SVB demise, that is far less likely to happen here. Our capital adequacy rules do a very good job of penalising banks for taking on risk. While the technicalities are complicated, the concept is simple. The more risk a bank takes on, the more equity capital it must set aside as a buffer. That includes the credit risk of a loan (the higher the probability of default, the more capital must be set aside). But it also forces a bank to set aside more capital if it takes on market risk or interest rate risk.

That's why our banks don't offer competitive long-term, fixed-rate mortgages. If a bank funds a long-term loan with short-term deposits, the capital requirements make the loan uneconomical. The three- and four-year fixed-rate loans offered during Covid were matched with temporary fixed-rate funding from the RBA.

You could (and plenty of people do) argue whether home loans are as safe as our capital adequacy rules assume. But our regulatory regime is far more robust than the one that governs small banks in the United States.

EXTREME VALUE IN SMALL CAP LAND

I recently spent some time on the phone with **Macmahon** CEO Mick Finnegan. It has now been more than six years since Mick and I fought off an opportunistic bid for Macmahon by Spanish-owned construction giant CIMIC.

A quick glance at the company's financial statements and you would think we made the right decision. Mick and his team have grown Macmahon's operating profits every single year since the offer was rejected. Macmahon made $94m of operating profit in the 2022 financial year, almost triple the $34m it made in 2018. The company has guided to more than $100m for the 2023 financial year and recently announced several important contract extensions that mean it should grow further in 2024.

Look at the share price, though, and you could argue that we should have cut and run. On the day of our phone call, Macmahon shares were trading hands for $0.13 a share, roughly 10% below the $0.145 CIMIC was offering six years ago.

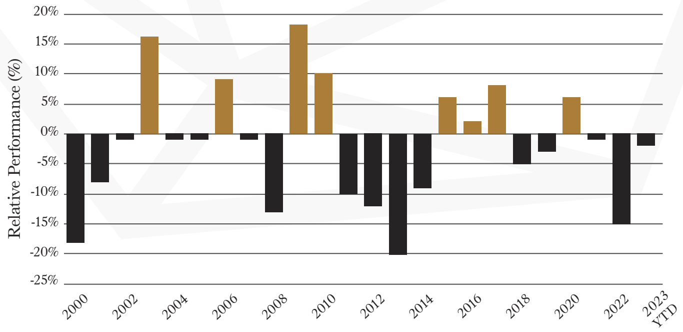
There have been a few cents in unfranked dividends along the way but the total return is close to zero. Thanks to the earnings growth, the value attributed to the whole company is now less than five times this year's profits.

Mick is scratching his head and frustrated. So am I, to a lesser extent. He has done almost everything we asked six years ago and has little to show for it (his long-term incentives are well out of the money).

It is probably not much consolation, but he's not alone. Several companies in which the Forager Australian Shares Fund is invested reported very encouraging results in February. By the end of March, their share prices were wallowing back near the lows of 2022.

That six-year period since CIMIC's bid for Macmahon coincided with a horrible period of underperformance for Australian small caps. After a glimmer of optimism in January, small companies have given up all of their 2023 outperformance and then some.

ASX SMALL ORDS INDEX CALENDAR YEAR RELATIVE PERFORMANCE TO ASX ALL ORDS INDEX (%)



Source: Bloomberg

There is not much Mick or Forager can do about the market value attributed to Macmahon's shares. But they can make the share price a lot less painful.

Mining services is a capital intensive industry. Macmahon's growth has required capital and limited the amount of dividends the company has paid. Last year it paid just 25% of profits to shareholders as dividends.

The growth phase is coming to an end and it is time for shareholders to see a larger share of those profits in our bank accounts. A 75% payout ratio would equate to a 15% yield on Macmahon's shares, something likely to get other investors' attention. Even if the attention stays low, 15% p.a. makes for an excellent investment.

Each company has a unique set of problems to address. Some of our investee companies are still recovering from Covid-related disruptions. Others face falling demand for their products as consumers navigate higher interest rates.

Our message to all of them is the same, however. Stay focused on maximising the value of the business over the long term. Deliver on the business's profit potential, invest incremental capital only where the prospective returns are high and, where appropriate, make those results tangible by returning cash to shareholders.

Execute on those three things and the share price becomes a sideshow.

Kind regards,

Steven Johnson
Chief Investment Officer