Firetrail Australian High Conviction Fund

MARCH 2019

ABOUT FIRETRAIL

Firetrail is an investment management boutique which is majority owned by the Firetrail investment team. Additionally, the investment team is invested alongside clients in the investment strategies.

AUSTRALIAN HIGH CONVICTION FUND

The Australian High Conviction Fund ("Fund") is a concentrated portfolio (approx. 25 companies) of our most compelling equity ideas. The strategy is built on fundamental, deep dive research guided by the philosophy that 'every company has a price'.

INVESTMENT OBJECTIVE

The Fund aims to outperform the ASX200 accumulation index over the medium to long term.

FUND PERFORMANCE TO 31 MARCH 2019

	Net Fund	Benchmark	Net Excess
1 Month (%)	(0.24)	0.73	(0.97)
3 Months (%)	9.65	10.89	(1.24)
1 Year (%)	1.61	12.06	(10.45)
Inception (% p.a.)	(0.72)	8.39	(9.11)

Net Fund returns are in AUD terms. Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. Past performance is for illustrative purposes only and is not indicative of future performance.

FUND DETAILS

Unit prices	29 March 2019
Application price	$0.9911
Redemption price	$0.9861
NAV price	$0.9886

Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Number of Holdings	24
Fund size	$354m
Management fee*	0.95% p.a.
Performance fee*	15% of outperformance

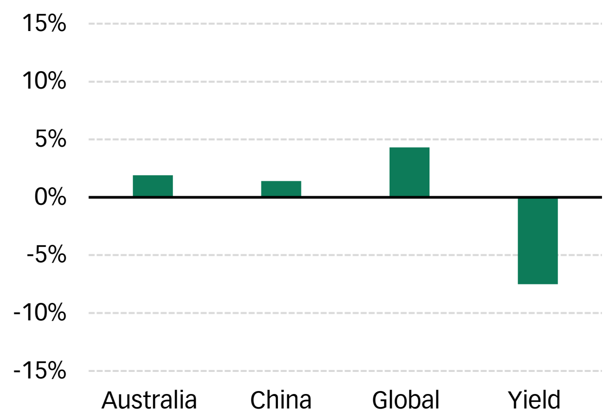
*Please read the Product Disclosure Statement for more details

PORTFOLIO POSITIONING 31 March 2019

Top 3 Overweight Holdings (Alphabetical)
Amcor Ltd
Woolworths Group Ltd
WorleyParsons Ltd

THEMATIC POSITIONING 31 March 2019

Relative to the Benchmark



PORTFOLIO COMMENTARY

The Fund returned (0.24%) for the month ending 31 March 2019, underperforming the ASX200 Accumulation index by 0.97%.

For the quarter, the Fund returned 9.65% underperforming a strongly rising ASX200 which rose 10.89%. It was an exceptionally strong quarter for the Australian equity market, and it felt like a 'melt up'. Statistically, the market rose 38 days out of 62 trading days (61%). The trigger for the rally was an enormous pivot by the Fed Reserve to a more neutral stance on rates. Volatility collapsed (only 6 out of 62 trading days moved >1%) and the market rose strongly.

FINDING OPPORTUNITIES IN THE 'UNLOVED'

The Firetrail team are excited about the stock specific opportunities in front of us at the moment. Some of the companies that we own, such as Clydesdale Bank and Nufarm, are definitively unloved after falling >30% in recent times. But ironically, these are the stocks that present the most upside opportunity. In recent time, we have seen companies that were undervalued when we invested, become even more undervalued as incremental news on temporary issues such as Brexit and the drought was worse.

We are always seeking more information and alternate angles to confirm or disprove our investment thesis. Sometimes we need to move on and take losses, as we did last year when exiting Fletcher Building. In Fletcher, we saw a promising turnaround story. Last year, when we refreshed our view on the housing and building materials cycle, we made the call that the housing downturn was going to overpower the best efforts of management and exited the position. But in other cases, such as Clydesdale Bank, we increased our position in the quarter, as we don't believe the story has changed, yet the share price has materially fallen on a combination of Brexit and company earnings concerns.

Over time, the strategy we run has made money from investing in the 'unloved'. We have witnessed firsthand, how material investor returns can be made when market perceptions change. Some examples include:

Qantas

- <u>2014 market perception</u> – poorly run company, likely to be bailed out by the Australian Government operating in an industry that never markets money
- <u>2018 market perception</u> – well-run company, material excess cashflow, operating in a highly rational domestic duopoly
- <u>Investment return</u> – Over 4x initial investment

Bluescope

- <u>2014 market perception</u> – high cost steel manufacturer operating in an industry that will never make money
- <u>2018 market perception</u> – well run, low cost steel company with a pristine balance sheet
- <u>Investment return</u> – Over 4x investment

While we never know what share prices will do in the short term, we do have a view on how the market's perception is likely to change for some of the companies we own. Here are some simplified examples:

Nufarm

- <u>Perception today</u> – a business heavily reliant on weather and the threat of legal action around a key product they distribute
- <u>Future market perception</u> – a focused, global market share winner with high value IP in the aquaculture space

Clydesdale Bank

- <u>Perception today</u> – a highly risky, sub-scale bank with huge exposure to Brexit risk
- <u>Future market perception</u> – a low cost challenger bank with market share opportunities from operating under Virgin, one of the top brands in the world

Downer

- <u>Perception today</u> – a cyclical, risky play in the engineering and construction industry
- <u>Future market perception</u> – a well-run, low-risk, diversified engineering and services company

Whilst we do not know exactly when the market's perception on Nufarm, Clydesdale and Downer will change, we have high conviction that all three companies will be material opportunities over the medium to long term for our investors.

PORTFOLIO POSITIONING & PERFORMANCE IMPACTS

When it comes to portfolio construction, we believe in high conviction positioning combined with balance across major themes such as China, Global, Australia and Yield. Some call the portfolio eclectic, given the diversity of opportunities across growth, value, large, small, industrials and resource companies. Owning an eclectic portfolio of companies gives balance through major sector rotations as well as through value and growth cycles. The portfolio construction means we spend less time thinking about the future direction of markets, and more time understanding the companies and industries we invest in. Over the medium to long term, our portfolio construction process ensures returns are driven by fundamental stock selection, where we believe we have an investment edge, as opposed to thematic or macroeconomic bets.

The strength in the market during the quarter was led by outperformance in Resources, REITs and technology. The portfolio is currently underweight REITs which detracted from performance. We are positioned slightly overweight the resources space via a large active position in Rio Tinto and a smaller position in Sims Metal. While resource markets are cyclical, and inevitably, the iron ore price will eventually come down, our research suggests iron ore is likely to remain higher over the short to medium term. Brazillian iron ore outages due to the devastating Brumadinho tailings dam collapse are likely to cause ongoing disruption in supply, meaning iron ore prices will remain well supported. You only need to look back to the major event of the Fukushima nuclear disaster in Japan in March 2011. The Fukushima event triggered a number of flow on effects including a boom in LNG markets and a collapse in uranium prices over the following years as Japan pivoted away from nuclear energy. Every situation is different, but with Brazil still reeling from more than 200 deaths, a cautious and restrictive stance on Brazillian iron ore production will continue. Rio was the top performing position for the quarter.

WorleyParsons was another top contributor over the quarter. We have written extensively about our investment thesis in WorleyParsons here. As a reminder, we believe WorleyParsons is set to benefit materially from the return of the oil and gas investment cycle. In our view, the investment thesis is playing out as expected, with WorleyParsons winning more contracts over the past 6 months to December 2018 than in 2015, 2016 and 2017 combined. We continue to see material upside in WorleyParsons and it remains a key position in our high conviction portfolio.

Nufarm was the key detractor to portfolio performance during the quarter after the company announced a mixed result and lower than expected guidance for FY19. There were three key issues of concern to the market:

1. **Balance sheet** – Net debt was $1.6bn, up from $1.4bn at the end of July 2018. Whilst increasing debt is always a red flag, further research indicates that the key driver was a $500m increase in working capital due to:
   a. A $200m increase in inventories as Nufarm builds product for the key selling season in the northern hemisphere; and
   b. A $300m increase in receivables due to strong sales in North and South America

   Nufarm has guided to Net Working Capital of $1.3-$1.4bn at the end of FY19, suggesting a $400-$500m unwind driven by collections in the 2nd half of the year. We will be watching this closely.
2. **Drought & Glyphosate concerns** – We have written extensively about both issues in a detailed article on Nufarm here. In our view, whilst disappointing in the short-term, both issues are cyclical in nature and Nufarm is well placed over the medium term as these issues are resolved.
3. **Production issues** – Simply put, Nufarm has been struggling to produce the chemicals it needs to keep up with sales demand. Part of this is due to the broader China environmental crackdown, and part is teething issues to do with a newly acquired portfolio. While disappointing, we believe Nufarm is very focused on solving the production issues and getting back on track.

Whilst our Nufarm investment has proven to be poor to date, much of the bad news is related to transitory issues such as weather and production. Our investment thesis remains unchanged. At 5X EV/EBITDA, Nufarm is trading at a material discount to peers and its historical valuation (through the cycle). With an undervalued core business and upside from the Omega 3 opportunity, we see significant upside to Nufarm over the medium-term. It remains a key position in our high conviction portfolio.

PORTFOLIO CHANGES

The portfolio entered into a new position in Orica during the quarter, largely due to continuing improvement in the explosives market. We also increased our position in Downer, Reliance Worldwide and Clydesdale Bank. Downer delivered a very strong result in February and is set up for continued earnings growth from core expertise in 'Urban Services' including transport, utilities and services. The end markets that Downer operates in have little cyclicality and strong structural growth. Clydesdale Bank and Reliance Worldwide showed they are delivering in their February results announcement and with compelling valuations on offer, we decided to allocate more capital to these opportunities. On the sell side, we trimmed some exposure to Link Group after the strong share price performance post the February result and exited a small position in Caltex with management turnover across the business resulting in a loss of conviction.

ONE INTERESTING THING THAT HAPPENED THIS MONTH…

Was a realisation of how big the social concerns arounds plastics are. The past few years have seen a banning of most high-profile single use plastics such as plastic bags and plastic drinking straws. But public opinion seems to be moving further against plastics, despite many tangible benefits they bring. 68% of UK citizens believe in the idea of eliminating plastics in modern life.

Some of the benefits of plastics are clear. For example, a cucumber wrapped in a thin film of plastic has a shelf life of 14 days. Without the thin film of plastic, the cucumber will only last three days. Once you consider the flow on impacts, such as producing four times more cucumbers, four times the logistics, you can start to think about real trade-offs. A July 2016 study found the full cycle environmental cost of plastics today is $139bn. Using alternatives to plastic would be $533bn, 3.8x more. The key contributors include raw material costs and logistics (heavier items).

To help solve some of the problem, and protect their business models, large chemical companies reliant on plastics as their end market are banding together to create the 'Alliance to end plastic waste'. The aim is to help protect the marine environment by collaborating on infrastructure, education and innovation. Having spent a fair bit of time on the issue, our strong belief is that the collection of waste is the primary issue, particularly in emerging Asian countries. Speaking to some large global waste management firms with both the capability and capital to be part of the solution, they are much more focused on their home markets because of some of the risks associated with putting material capital down in emerging markets.

There is plenty going on in the space, and we are at the early phase, but expect some big risks and opportunities.

MORE INFORMATION

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Firetrail INVESTMENTS