Past performance is not a reliable indicator of future performance.

1. Firetrail Absolute Return Fund ("Fund"). Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. 2. Fund inception is 14 March 2018. 3. The Fund has been operating since 14 March 2018. To give a longer-term view of our performance for this asset class, we have also shown returns for the Firetrail Absolute Return Strategy Composite ("Strategy") which has been operating since 30 June 2015. Strategy performance has been calculated using the monthly returns (after fees) of the Fund from 14 March 2018 to current date, as well as the monthly returns of the Macquarie Pure Alpha Fund (after fees) between 30 June 2015 to 23 November 2017. The Fund employs the same strategy as was used by the same investment team that managed the Macquarie Pure Alpha Fund as at 23 November 2017. Firetrail has records that document and support the performance achieved as the Macquarie Pure Alpha Fund. The composite returns for the Strategy and the RBA Cash Rate (Benchmark) exclude returns between 24 November 2017 and 13 March 2018. During this period the investment team did not manage the Strategy. As such, the annualised performance periods stated are inclusive of the combined composite monthly returns, and do not include the period when the team were not managing the Strategy. For example, the annualised return over 3 years for the Strategy and benchmark are inclusive of 36 monthly performance periods available in the composite return period, excluding the period between 23 November 2017 and 13 March 2018. For additional information regarding the performance please contact us through the link on our website. 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. 4. Strategy inception 30 June 2015.
PERFORMANCE COMMENTARY

The Fund returned 4.94% during December, outperforming the RBA cash rate by 4.88%. All three fundamental investment buckets were positive – with the large cap long positions, small cap long positions and the fundamental short positions contributing to the outperformance during the month.

It was a mixed bag for global markets in December – with the ASX200 Accumulation index falling 2.2%. Globally, the S&P500 Total Return index rose 3.0%, and the FTSE100 total return index rose 2.8%. One of the key reasons for the underperformance of the Australian equity market was the strength in the UK market post their election, plus the very strong end of year rally in US tech names.

TOP CONTRIBUTORS FOR THE MONTH

After being the largest detractor in November, a large cap long position in crop protection and seed technology company Nufarm was the largest contributor during the month. Whilst it is well known that crop growing conditions remain tough, during the month Nufarm also released a more detailed presentation on its seeds business (Nuseed) than we have seen to date. Of interest to us were two points:

1. The significant progress of land-based Omega-3 canola growing as an alternative fish feed source. In 2019 there was 35,000 acres, (or 140 square kilometres) of Omega-3 canola harvested. The Omega-3 business is expected to be earnings positive in FY21 and has the ability to scale rapidly.

2. We learnt more about Carinata – a crop similar with similar characteristics to canola – that can be grown and used as a biofuel. It has already been used in commercial aviation flights and burns cleaner than fossil fuels. Nufarm owns the proprietary germplasm (the genetic resources) for this, and expects rapid expansion in area planted. One of the key features of Carinata is that it is a winter cover crop, leaving the summer to have a crop such as soybean grown, enabling additional farmer income.

We believe there is significant upside in Nufarm from the commercialisation of its seeds business.

Two of the largest small cap long contributors in December were positions in IMF and Megaport. IMF is a global provider of litigation funding that has significantly changed its business structure over the past few years. Rather than taking risk on its own balance sheet as it has in the past, IMF now predominantly manages funds on behalf of investors for which it charges a management fee and a performance fee. Over its history IMF has had over a 90% success rate of the cases that it funds. We do support the more sustainable model of a fund-based approach to litigation funding – it is something that should attract a higher valuation multiple. It was a positive during the month that IMF won the Brisbane Floods class action case in court. Income from this is expected to be between $100-$130m (compared to IMF’s market cap of $1.1b). Although it is still subject to possible appeal from Queensland government entities. Whilst earnings can be lumpy depending on case wins and fund maturities – IMF has an attractive valuation at a Price to Earnings ratio of around 13x 1-year forward earnings.

Megaport rose 11% during the month, after a placement early in the month which raised $62m (market cap is $1.5b). Megaport is a unique technology company that provides “Network as a Service”. In other words, it provides a software-based method of transferring large volumes of data between servers in data centres. Traditionally this has been an expensive and clunky process of organising capacity with data centres and telcos. It is connected with 141 unique cloud services (eg Amazon Web Services) and is currently enabled in >500 data centres globally. The additional capital raised enables the company to expand even more rapidly – with another 9 countries to be added in the next 18 months. Despite the loss-making nature of the business currently we are highly supportive of Megaport building a strong first mover advantage with is technology, and a DCF valuation shows upside.

The majority of the positive contribution was from the long portfolio in December, as there was a lack of identifiable fundamental short catalysts during the month. However, a key contributor from the fundamental short portfolio included a stock in the gaming sector in December that announced an earnings downgrade of ~15%. January is a period where we increase the number of fundamental shorts in the portfolio as we approach the catalysts of company reporting in February.

TOP DETRACTORS FOR THE MONTH

A large cap long position in Lendlease was one of the largest detractors during the month. It was announced that the company had sold its engineering business (a long-awaited transaction!) to Spanish contractor Acciona. Whilst on the face of it this is great news as it enables Lendlease to pivot back to its core activities of property development and investment management, the deal excluded the troublesome Melbourne Metro contract. The stock fell 5% the day after the sale was announced.
Despite the retention of the Melbourne Metro contract (for now at least), there is still plenty of upside in Lendlease by individually valuing each of its businesses, as well as a liability for the Melbourne Metro contract. LLC did not increase provisions or costs to dispose of the engineering business as they announced the sale, which we take as a positive. Investor’s don’t seem to like uncertainty – such as an unquantified liability – yet our scenario analysis gives us comfort. We see opportunity! With the large infrastructure pipeline to be built in Australia over the next few years, there is also likely to be more sharing of risk between governments and contractors in order to retain high quality operators in the market.

Positions in **Woolworths** and **Telstra** were also detractors during the month. We believe Woolworths is going through a sustained period of sales outperformance as it takes share from Coles as Coles goes through a period of reinvestment. Telstra has upside particularly from its mobiles business (its largest division) as we see increasing evidence of rationality between the three Australian operators (Telstra, Optus and Vodafone).

**ONE INTERESTING THING THAT HAPPENED THIS MONTH…**

A decomposition of the drivers of the returns of the ASX 200 index over the past 5 years, as shown in the picture below. The 23% return seen in 2019 was all driven by an expansion in the Price to Earnings ratio for the overall index (from 14.3x to 17.5x), with earnings changes actually detracting 4% from returns! This comes after 3-years of earnings changes contributing positively to returns from 2016 to 2018.

![ASX200 Total Return Attribution](image)

Whilst 2018 and 2019 are two years where the clear driver of returns has been changes in the valuation multiple, we would point out that these are anomalies. 2018 saw a contraction in the multiple from global macro concerns, whilst 2019’s expansion can largely be explained by low interest rates. However over the long term the largest driver of returns is by far and away the change in earnings of a company or index. As we go into 2020, we believe more emphasis will be placed on earnings changes as a driver of stock returns, given that interest rates have moved significantly lower already, and multiples are already significantly expanded. But we also stick to our knitting and focus on identifying individual company investment opportunities – this is where we know our skill set is!