Firetrail Absolute Return Fund

AUGUST 2020

PERFORMANCE (AFTER FEES)

	Month	Quarter	6 Months	1 yr	Fund incept[2]	3 yrs (pa)	Strategy incept (pa)[4]
Fund[1]	1.42%	4.73%	14.48%	15.48%	4.94%	-	-
Strategy composite[3]	1.42%	4.73%	14.48%	15.48%	-	5.84%	12.80%
Benchmark	0.02%	0.06%	0.14%	0.54%	1.07%	1.12%	1.37%
Excess Return	+1.40%	+4.66%	+14.34%	+14.94%	+3.88%	+4.72%	**+11.44%**

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.

ABSOLUTE RETURN FUND

The Absolute Return Fund ("Fund") is a market neutral strategy with minimal correlation to equity market direction. It aims to generate positive returns in all market environments. 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 RBA Cash Rate over the medium to long term.

PORTFOLIO POSITIONING 31 AUGUST 2020

Top 3 Long Holdings (Alphabetical)
Chorus Ltd
Newcrest Mining Ltd
Qantas Airways Ltd

FUND DETAILS

Unit prices	31 August 2020
Application price	$1.1304
Redemption price	$1.1191
NAV price	$1.1248

Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception date	14 March 2018
Fund size	$228mil
Management fee*	1.50% p.a.
Performance fee*	20% of outperformance

*Please read the Product Disclosure Statement for more details

FUND EXPOSURE 31 AUGUST 2020

	Portfolio Exposure
Long Equity	190.0%
Short Equity	(190.0%)
Net Equity Exposure	0.0%

Past performance is not a reliable indicator of future performance.

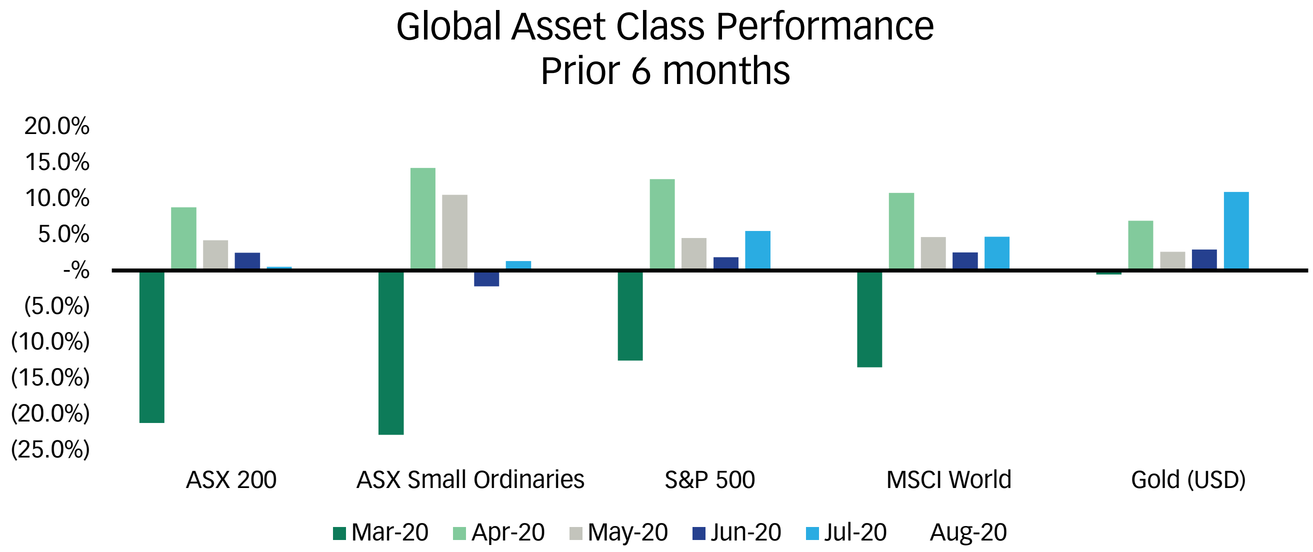
1. Firetrail Absolute Return Fund ('Fund'). Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. **2.** Fund inception is 14 March 2018. **3.** The Fund has been operating since 14 March 2018. To give a longer-term 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 Firetrail Absolute Return Fund returned 1.42% during August, outperforming the RBA Cash Rate benchmark by 1.40%. The largest contribution to performance was from the mid and small cap long positions.

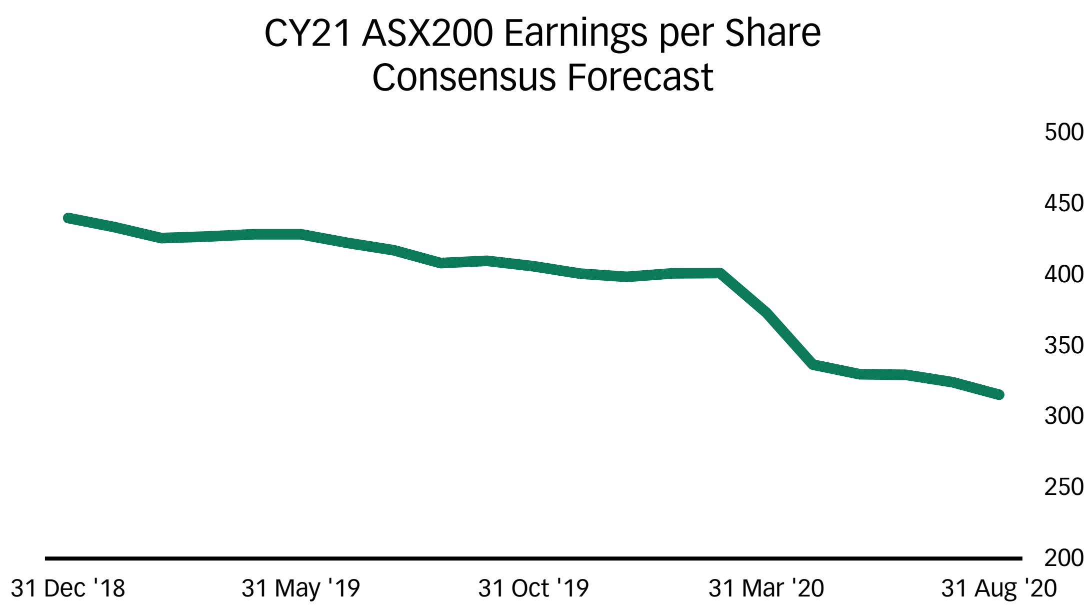
WHAT HAPPENED IN MARKETS?

Asset class performance in August was strongly positive across all global equity indices, whilst the gold price fell 0.4%. The 2.2% rise in the ASX200 significantly lagged global indices by 4-5%, one of the largest underperformances we have seen in a single month. As a market neutral fund, this underperformance does not impact us - the opportunities for generating returns are more dependent on individual stock moves either up or down.



Source: Firetrail, Factset

August involved the reporting of full year results for most ASX listed companies. Guidance for FY21 was minimal - companies are taking a prudent approach as expected in this environment. Market earnings were downgraded during the month, although only by 3% for the ASX200. There is plenty of noise and stimulus distortions in short term earnings, thus we prefer to look out at CY21 when thinking about how much these 'normalised earnings' have changed. Sell-side analysts are an optimistic bunch that listen to optimistic company management. Therefore, over time we do tend to see more downgrading than upgrading of earnings. Compared to the typical ~2-3% downgrades we see during a year, the downgrades to CY21 forecasts so far this year have been 21%. The one year forward market Price to Earnings ratio is now a little over 20x, compared to the 18x PE that we saw before the COVID impacts on the market.



Source: Factset

One of the key factors we will watch over the next few months will be the market reactions to the withdrawal and reduction of government stimulus. In Australia, the JobKeeper wage subsidy is currently slated to reduce from $1500 currently, to $1200 in October, and then $1000 From January 2021. Unless economic conditions improve this will place pressure both on company's cost bases, as well as employment from a macroeconomic level. The two super withdrawal rounds have also now occurred, with some of this appearing to prop up retail sales. One offset, to markets at least, may be the continued monetary stimulus – with central banks around the world continuing to indicate that they will hold rates at low levels for a sustained period of time. The cheap money continues!

KEY PORTFOLIO CONTRIBUTORS

The top 3 contributors during the month were long positions in **Qantas, Mesoblast** and **FINEOS**.

Qantas

Qantas was the top performance contributor for the month. After announcing a $1.36b equity raise in late June, Qantas reported its full year results in August. It was an undeniably tough FY20 for Qantas, and FY21 will also be tough as flying remains limited in the domestic market, and likely non-existent in the International market. However, this is well known, and to us, this is an opportunity for significant returns as we look further out at the prospects for the airline. The domestic businesses (both Qantas and Jetstar) and Qantas Loyalty (i.e. frequent flyer) represent the majority of value in the airline. The frequent flyer business has remained both earnings and cashflow positive, thus as we analyse Qantas, we are focussing on two things:

1. What is the medium-term outlook for the domestic market?
2. What are the impacts of short-term cash burn on the medium-term balance sheet?

Firstly, the key driver of returns in the domestic market will be driven by competition. Like a commodity, airline returns can be thought of as being driven by supply of planes and demand from passengers. Demand is typically steady, and almost correlated with GDP – there isn't too much edge to be gained by predicting demand. However, analysing the supply of airplanes is much more important – and in Australia this is driven by the actions of two airlines – Qantas, and secondly the new look Virgin as it rises out of voluntary administration. Our analysis suggests that Qantas and Jetstar will have ~70% market share, with the new look Virgin having ~30%. This gives Qantas a higher share of the market than it has had in the past, while all signs from Virgin's likely new owner's (private equity investor Bain Capital) suggest they are happy to be a smaller, more profitable airline. Bain, after all, is invested in Virgin to make a return – rather than the prior Virgin which played to the needs of its foreign owned airline shareholders.

Secondly, as we think about valuation, we need to take account of the current cashflow impacts on the balance sheet. Right now, we believe Qantas is losing around $60m cashflow per week – primarily through funding redundancy costs, paying refunds, and also paying suppliers that gave Qantas extended payment terms. This level of cash burn will reduce into calendar year 2021, even if current conditions are maintained. We believe Qantas' $4.5bn liquidity is sufficient to ride through the crisis and absorb this cash burn, and credit markets also agree, with Qantas able to issue a $500m unsecured 10-year bond in the month. With risk being mitigated here, our focus returns to the pathway back to positive free cash flow. If Queensland and Victoria open their borders, then Qantas could quickly move back to a 50% capacity setting (vs current 20%) – at which level it could be in a break-even cash flow position. We are not relying on international borders reopening any time soon.

Our base case valuation for Qantas looking forward 3 years implies valuation upside of greater than 50%.

Mesoblast

Mesoblast was the largest contributor from the small cap long positions. A volatile week in the middle of the month was capped off positively by an Advisory Committee of the US Food and Drug Administration voting 9-1 in favour of the efficacy of one of their treatments. This treatment (remesteamcel-L) was found to have efficacy in the treatment of certain side effects of children's bone marrow transplants. The treatment has already been in use in Japan for a number of years. Whilst this treatment application has a small global market, the approval marks a significant step for the company. It is the most progress the company has made with the FDA to date on its cell therapies. It is a sign, albeit small, that the door may be opening to further therapies. The shares were up over 40% during the month.

FINEOS

Insurance software provider FINEOS shares rose, which we have held since the company listed on the ASX in August 2019. Two things drove the share price higher during the month. Firstly, FINEOS acquired Limelight Health, which builds its capability in the sales side of insurance and gives access to further customers. Secondly, as a pure play insurance technology provider there has not been much for FINEOS to be compared to. That changed in the month as US company Duck Creek Technologies listed on the NASDAQ. The shares of Duck Creek were up 60% during the month, showing the significant investor interest in the space.

The largest detractors in the month were long positions in Newcrest Mining, Aroa Biosurgery and a short position in the technology sector.

Newcrest Mining

The fund's long position in Newcrest Mining underperformed, not only due to the flat gold price in a rising market, but also a weaker than expected update from the company. Production at the company's Lihir mine in Papua New Guinea will be ~12% lower in FY21 than what the market had been expecting. This mine is at a stage where it has to process heavy clays – a more intensive undertaking. Whilst impacts will go across FY21 and FY22, after this clay has been mined it is likely production will increase again, as well as costs reduce. A case of short-term impacts, with a positive long-term outcome. We remind investors that amongst major global gold miners, Newcrest has the longest mine life at 23 years of production based on current plans. It remains a core holding with significant upside.

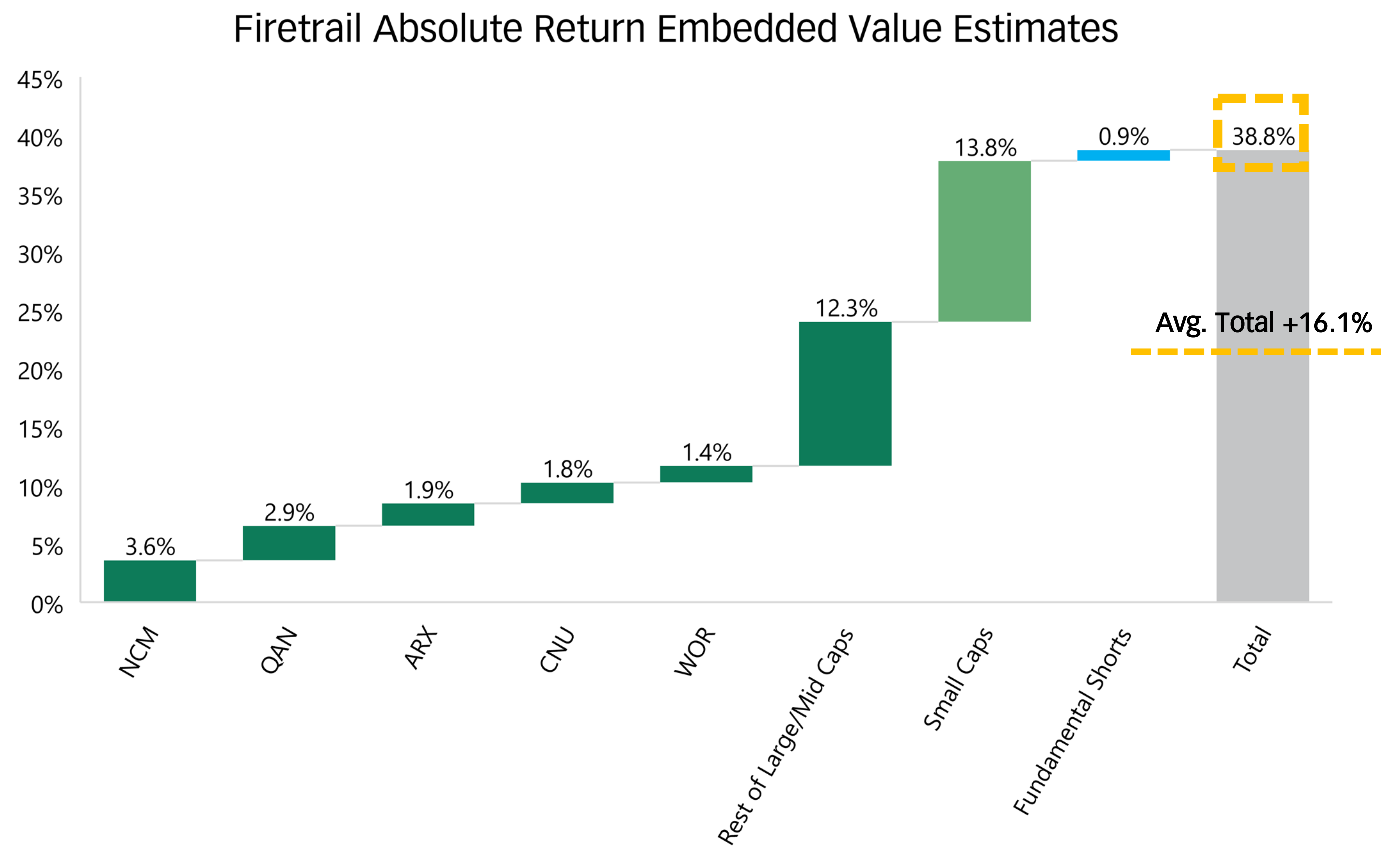
Short positions were a small detractor from performance during the month. Whilst earnings downgrades were prevalent and sell-side analysts had to make significant negative revisions to their forecasts, expectations were already very low from investors. Our rule of avoiding the 'crowded shorts' played true during the month – as those stocks with the highest level of short interest were some of the best performers in the entire market.

PORTFOLIO POSITIONING & OUTLOOK

Despite the strong portfolio performance over the past 12-months, we continue to see elevated opportunities across equity markets to add value from our long and short positioning. However, risks are also elevated. One key risk for equity markets we are debating at Firetrail is whether a COVID-19 vaccine would be a positive or negative development for the future direction of equity markets?

The general consensus today is that a vaccine would be good for the global economy and equity markets. But as we have seen in the past, equity valuations do not necessarily reflect the health of the economy. The key risk to the thesis that a "vaccine = good for equity markets" is the potential inflationary impact this may have, particularly when you consider the amount of fiscal and monetary stimulus that has been provided to economies globally to get inflation moving again. At Firetrail, we can see a scenario where a vaccine actually has an inflationary impact, which could flow through to rising bond yields. Even a small rise in yields could have a material impact on valuations for companies with longer dated cashflows (technology, bond proxies etc.). However, cyclically exposed businesses would likely benefit from any inflationary impacts which may offset the impact of falling valuations in other parts of the market. And whilst the direction of the market as a whole is unknowable, there is no doubt that risks are elevated in pockets of the market and that many investors portfolios may not be adequately diversified from exposures to a potential change in market conditions.

That is not the case for the Firetrail Absolute Return Portfolio Positioning. From a portfolio perspective, we are comfortable that there is enough breadth of style exposure (currently neutral value vs growth) and defensive vs cyclical exposure (the portfolio is overweight defensives such as gold companies and overweight cyclicals) to be able to generate positive performance if a change in market cycle were to happen. Most importantly, we continue to focus on valuation and earnings in our long portfolio and believe we have a good mix of undervalued value/growth/, large/small, industrials/resources companies across the portfolio. Importantly, our short positioning ensures that **1.** The portfolio remains net market neutral, which ensures the portfolio is uncorrelated to (independent from) market directional movements and **2.** We control our thematic risk exposures to reduce the portfolios exposure to binary macroeconomic risks such as movements in bond yields (positive or negative), trade tensions and global growth. The key driver of returns is long and short stock selection – driven by our deep fundamental research approach. And when we look at the stock specific opportunities across the portfolio today (see Embedded Value Estimates below), we have never been more excited. The most important thing to note, is that our Embedded Value Estimates for the next 2-3 years, are irrespective of market movements. In today's environment, we believe the Fund provides much need risk and return diversification in a period of heightened risk but also heightened opportunity.



ONE INTERESTING THING THAT HAPPENED THIS MONTH…

Was the slew of positive 'like for like' sales updates the discretionary retailers gave as they reported. As the ability for these companies to give guidance is very limited, a lot of focus is on the trading updates companies give for the period from 1 July to the date of their reporting in August.

The very best updates were from the online retailers, with the sales numbers from Kogan being up 110%, and furniture retailer Temple and Webster up 161%. The 'bricks and mortar' stores didn't do too badly either, with JB Hi-Fi sales up 44%, Harvey Norman up 38% and even Coles and Woolworths up 10% and 12% respectively.

In '*normal'* times these trading updates would be taken extremely well – and share prices would rocket correspondingly. And some of the share prices did outperform. But the bigger question we are considering is how much of this sales uplift is either a) a catch up of demand or b) related to the additional stimulus (JobSeeker / JobKeeper / Superannuation Withdrawals) in the economy. To us it is clear that this level of spending from consumers cannot continue, and if we fast forward 12 months, it is likely that we will be looking at large negative 'like for like' sales.

MORE INFORMATION

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