

FIRETRAIL ABSOLUTE RETURN FUND

MONTHLY REPORT | JANUARY 2023

PERFORMANCE (AFTER FEES)¹

	Month	Quarter	1 Year	3 Years p.a.	Fund inception p.a. ³	5 Years p.a.	7 Years p.a.	Strategy inception p.a. ⁵
Fund ²	(3.94%)	(0.76%)	(17.59%)	1.49%	0.68%	-	-	-
Strategy composite ⁴	(3.94%)	(0.76%)	(17.59%)	1.49%	-	0.65%	4.31%	7.15%
Benchmark	0.26%	0.75%	1.53%	0.63%	0.88%	0.88%	1.10%	1.15%
Excess Return	-4.20%	-1.50%	-19.12%	+0.86%	-0.21%	-0.23%	+3.21%	+6.00%

1. Past performance is not a reliable indicator of future performance.

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 (after fees).

PORTFOLIO POSITIONING 31 JANUARY 2023

Top 3 Overweight Holdings (Alphabetical)
CSL Ltd
Newcrest Mining Ltd
Santos Ltd

FUND DETAILS

Unit Prices	31 January 2023
Application Price	\$1.0166
Redemption Price	\$1.0096
NAV Price	\$1.0131
Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception Date	14 March 2018
Risk/Return Profile	High
Fund Size	\$305mil
Management Fee*	1.28% p.a.
Performance Fee*	20% of outperformance above an annual Hurdle

*Please read the Product Disclosure Statement for more details

FUND EXPOSURE 31 JANUARY 2023

	Portfolio Exposure
Long Equity	189.4%
Short Equity	-189.4%
Net Equity Exposure	0.0%

Past performance is not a reliable indicator of future performance.

The Product Disclosure Statement ('PDS') and Target Market Determination ('TMD') of the Fund are available at <https://firetrail.com/firetrail-absolute-return-fund/>.

2. 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. 3. Fund inception is 14 March 2018. 4. 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. 5. Strategy inception 30 June 2015.

PORTFOLIO COMMENTARY

The Fund returned negative 3.94% (after fees) for the month ending 31 January 2023, underperforming the RBA Cash Rate by 4.20%.

In January, we saw a reversal of the trends that drove positive performance for the Fund in November and December 2022. Unfortunately, the reversal was sharp, offsetting the gains experienced in the previous two months.

The key detractors were short positions in Growth and Consumer names. Sentiment around the trajectory of interest rates and China re-opening dominated headlines and share price movements in January. The exception was Energy, where we have long exposure, which sold off despite increased demand for oil as China re-opens. Gold also retraced its earlier gains as rate expectations eased, despite historically having an inverse correlation to rates (when rates fall the gold price typically rises).

We continue to see attractive opportunities in Gold and Energy names. Newcrest Mining and Santos are the two largest holdings in the portfolio. We believe the market is underappreciating the quality of both companies' assets and their future earnings potential. Both Newcrest and Santos are trading at material discounts to our DCF valuations and global peers. Despite the January rally, we remain wary of consumer-exposed companies as we see heightened earnings risk due to higher costs, high inventory levels, and a constrained consumer.

The past twelve months have been a challenging period for portfolio performance. We have not met investors' or our own expectations. However, we have high conviction that the strategy will deliver for our investors as it did in 2020 and 2021.

Our long-term investors will know that some of our strongest periods of outperformance are following challenging performance periods. We believe markets are set up for a period of strong outperformance for bottom-up stock pickers. And our high conviction approach to long and short stock selection is well-suited to deliver outperformance over the medium-term, irrespective of equity market direction.

Our investment team co-invests alongside our investors in the Fund. We believe having skin in the game and alignment with our investors is critical to ensure the best long-term outcomes. In January, the investment team contributed more capital into the Fund given our high conviction in the positioning and outlook for the strategy.

CONTRIBUTORS TO RETURNS

Positive contributors to monthly returns included long positions in Lynas Rare Earths, Mineral Resources, and James Hardie Industries. Detractors included long positions in Santos, Origin Energy, and Incitec Pivot. We discuss each further in our commentary below.

POSITIVE CONTRIBUTORS

Lynas Rare Earths

Lynas Rare Earths outperformed during the month. Outperformance was driven by the reopening of the Chinese economy and a strong quarterly update. December quarter production of Lynas' main rare earth product, NdPr, improved 44% on the September quarter as water outages in Malaysia were successfully rectified.

Mineral Resources

Mineral Resources outperformed in January despite reporting a slightly weaker than expected quarterly result. Short term downgrades were offset by upgrades to FY24-25 earnings, driven by higher hydroxide production and improved sentiment around iron ore pricing following a full China reopening. We continue to believe the current share price undervalues the growth optionality of Mineral Resources' lithium and emerging Perth Basin assets.

James Hardie Industries

James Hardie Industries outperformed in January driven by softer inflation indicators and the prospect of a pivot in the US Fed's interest rate setting policies. There were also some positive signs in the US housing market. A number of US homebuilders reported better than expected buyer traffic and new order growth in January.

NEGATIVE CONTRIBUTORS

Santos

Both the Santos share price and the USD oil price were flat in January, trailing the 6.2% performance of the ASX 200. Santos reported a largely in-line quarterly production report. Another quarter of strong cash flow reduced gearing to 18.7% as at 31 December, below the mid-point of Santos’ 15-25% target range.

Origin Energy

Origin shares underperformed during the month. Absence of a binding offer from the Brookfield/EIG consortium despite an extension of the exclusivity period weighed on the shares. Corporate interest aside, Origin provided a positive earnings update driven by the Energy Markets business. As a result, the market increased earnings expectations for FY23-24 as a result of new customer wins and stronger electricity business operational performance.

Incitec Pivot

Incitec Pivot underperformed in January. Falling ammonia and fertiliser prices appear to be the main driver, reflecting lower European gas feedstock costs due to a warmer than expected winter. We expect gas prices to head higher once Europe begins to restock for next winter. We also expect an update on the potential sale of the Waggaman ammonia facility at the upcoming AGM. A sale could be a catalyst for major share buybacks in the coming periods.

PORTFOLIO POSITIONING

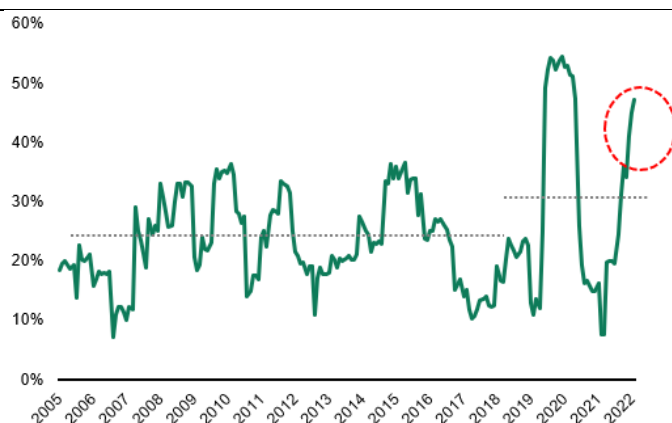
The Firetrail Absolute Return Fund is a market neutral portfolio (long/short) with zero net market exposure and beta (+/- 0.1) to ensure Fund performance is uncorrelated to the equity market. The portfolio is designed to be driven by long and short stock selection, as opposed to market movements.

The past twelve months have been challenging for stock selection and Fund performance. Alternatives that have fared best during the past year have typically been momentum and sentiment-driven strategies. These trend following strategies do well during periods where stocks become highly correlated and macroeconomic sentiment drives share prices, as opposed to fundamentals.

As seen in Figure 1, 2022 was a period where stock correlations rose to extreme levels typically only seen during large dislocations such as COVID-19 and the GFC. Over the past twenty years, there have been five periods where correlations have risen above 30%. At current levels, we believe share price correlations are near their peak. As stock correlations fall, markets tend to focus back on fundamentals such as valuation and earnings. The result is an increase in share price dispersion. Share price moves reflect their fundamentals instead of moving blindly together based on the latest macroeconomic indicator.

This is where the big opportunities emerge for fundamental stock pickers. In fact, some of our biggest outperformance periods have been when stock correlations are falling from elevated levels. We believe current conditions have set up exceptional long and short stock opportunities. Similar to our experience investing through COVID and the GFC, we believe our bottom-up approach can generate material outperformance in the coming 12-24 months as market focus shifts towards fundamentals.

Figure 1: ASX 200 stock correlations rose above GFC levels in 2022, reflecting a market driven by macroeconomic sentiment rather than fundamentals.

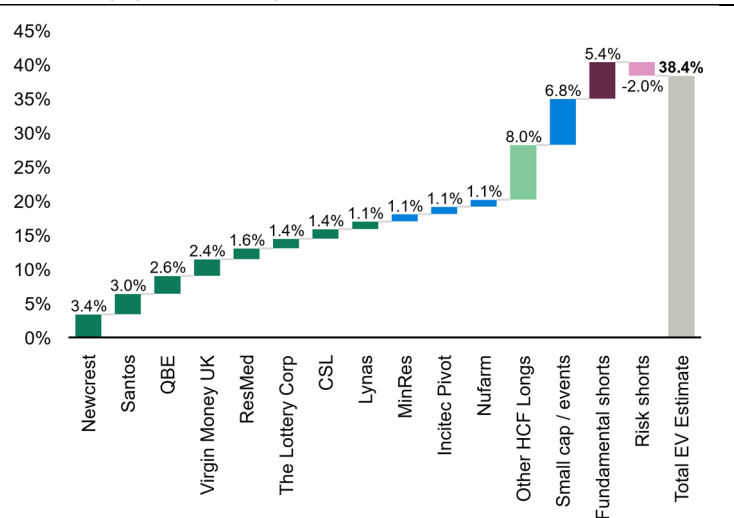


Source: Firetrail, Factset

One measure we use to assess the potential opportunity set within the portfolio is Embedded Value. Our Embedded Value estimate provides the potential portfolio upside based on our valuation and 3-year earnings forecasts for each stock in the Fund.

Today, the Embedded Value is sitting at near records at 38.4%. The only time it has been higher was during the COVID pandemic in 2020, a year in which the Fund delivered +19.5% after fees versus the ASX 200's +2%. While the Embedded Value estimate is dynamic and is an estimate based on what we know today and our own forecasts, it re-enforces our view that fundamental opportunities are elevated in today's market. We see material upside over the next three years, irrespective of equity market direction.

Figure 2: Firetrail Absolute Return Fund Embedded Value estimates (3-year forecast)



Source: Firetrail, Factset

Overall, we believe that the Fund remains well balanced. The long portfolio is tilted toward stocks and sectors where we see the biggest upside over the next three years. The longs are offset by shorts in stocks where we see elevated earnings risk over the short-term (<12-months).

The long portfolio can be summarised as:

- 189.4% long exposure across 40 to 60 stocks with upside based on our medium-term forecasts.
- Overweight Energy, Gold, Rate-Sensitive Financials, and high-quality Growth companies that we believe have been oversold in recent market volatility.
- Overweight value / cyclicals which remain undervalued with underappreciated medium-term earnings.

The short portfolio can be summarised as:

- 189.4% short exposure across a diversified portfolio of earnings shorts and risk-reducing shorts.
- Earnings shorts aim to profit from falling share prices because of earnings downgrades. The current market environment is creating heightened shorting opportunities as companies deal with supply chain issues, rising costs, and changing consumer preferences.
- Risk-reducing shorts offset equity exposure risks and control portfolio risks such as style (value/growth), size, sector, and thematic biases to ensure returns are driven by stock specific risk (not macro risk).
- The short portfolio is currently overweight expensive Bond Proxies, Consumer Staples, and Consumer Cyclical where we see material earnings risks and elevated expectations.

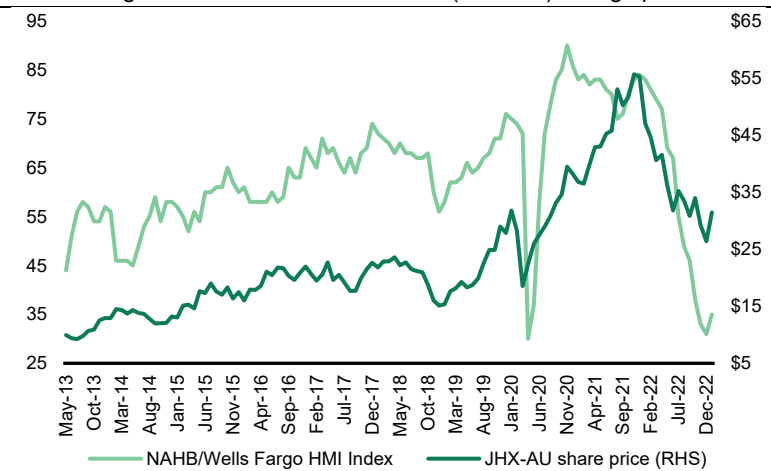
ONE INTERESTING THING THAT HAPPENED THIS MONTH...

After a challenging second half of 2022, signs are emerging that the US housing sector may have found a bottom.

The National Association of Home Builders (NAHB) Index, based on a monthly survey of US home builders and contractors, provides a pulse of the US single-family housing market. The Index turned positive in January after a precipitous twelve consecutive monthly declines in builder confidence levels.

The NAHB Index is a leading indicator for the overall housing market. The positive January reading could indicate a rebound in home building starts is near. More home building means higher sales of portfolio holding James Hardie's fibre cement siding products.

Figure 3: The NAHB Index has historically been a leading indicator for US housing and sales of James Hardie's (JHX-AU) sidings products



Source: Firetrail, Factset

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Links to the Product Disclosure Statement: [WHT5134AU](#)

Links to the Target Market Determination: [WHT5134AU](#)

For historic TMD's please contact Pinnacle client service Phone 1300 010 311 or Email service@pinnacleinvestment.com

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