AIRLIE AUSTRALIAN SHARE FUND (ASX TICKER: AASF)

The Fund aims to provide long-term capital growth and regular income through investment in Australian equities. The fund will hold a concentrated basket of between 15-35 quality Australian listed companies – Airlie's best ideas. Maximum cash holding of 10% with an aim to be fully invested.

Matt Williams,
Portfolio manager

Emma Fisher,
Portfolio Manager

PERFORMANCE

The Australian market rose 24% in the 12 months to June 2021, nearly 28% including dividends. Despite the strongest annual return for the Aussie market in over 30 years, the index actually underperformed most global peers, with the MSCI World Index returning a whopping 39% in USD terms. This was despite the fact that the Australian economy had proven much more resilient over 2021, with Australian GDP contracting only 2.4% in CY2020, vs US -3.5% and Europe -6.7%. Co-ordinated fiscal and monetary stimulus on an unseen scale drove global markets, as company profits, economic activity and confidence all recovered with an improving pandemic outlook.

The Airlie Australian Share Fund returned 33.7% after fees, exceeding the benchmark by 5.9%. The best performing stocks over the year included Mineral Resources, PWR Holdings, and Reece. Interestingly, all three are "owner managed businesses", cementing our view that founder-led businesses tend to make fantastic long-term investments. Mineral Resources' share price has risen 160% over the year, driven by record iron ore prices, lithium pricing improvements and strong mining services earnings. Put simply, the business is firing across all cylinders and is generating an incredible amount of cash flow. Given founder and CEO Chris Ellison's phenomenal track record of value creation (Mineral Resources has enjoyed a 20% return on invested capital over the last 15 years), we back the management team to allocate that cash wisely and drive future value creation in lithium and other commodities. PWR Holdings was a recent addition to the fund this year, and the share price has risen 50% since we first added it to the portfolio in January. Another family-owned business, PWR is an under-the-radar Aussie success story, exporting high-end radiators and cooling systems globally. The share price has risen to reflect the growing traction of the "emerging technologies" division, which we believe is poised to supply high-end cooling systems to electric vehicle manufacturers, as well as defence and aerial applications. Reece rose 150% over the year, reflecting improving end-market conditions in Australian and US housing markets. We are now three years on from Reece's acquisition of MORSCO, its US-based plumbing wholesale business. While at the time the deal had many characteristics we are usually terrified to see (a large purchase price from a private equity seller in a new market), we were confident that Reece's unique long-term focus and (rare) go-slow approach would pay dividends in unlocking the optionality of a market the size of the US. This appears to be playing out, with the US renovation market firing, and MORSCO profitability improving.

The stocks that detracted from performance included Aurizon and Waypoint REIT. The Aurizon share price fell 23% over the year. We would attribute this to (likely permanent) de-rating of the business due to the widening cost of capital for businesses in the thermal coal supply chain, as ESG focuses become more important for investors. Aurizon earns a third of its revenue from transporting thermal coal. We account for the dire long-term outlook for thermal coal in our cash flow expectations and discount rate, and remain attracted to the value on offer in Aurizon, with a near 10% dividend yield and strong free cash flow generation. The Waypoint REIT share price fell 2% over the year, with underperformance largely driven by an increase in bond yields related to increased market expectations of inflation, despite the company providing solid distribution guidance over the year.

OUTLOOK

We typically refrain from making economic (or market) predictions, simply because most economic forecasters (ourselves included) have woeful track records, but we make the following observations. The Australian economy is in the best shape it's been in in years. The strength is widely spread across the economy: from households enjoying rising house prices, falling mortgage repayments and emerging wage inflation, to miners reaping record commodity prices, farmers rebounding from the drought and banks experiencing renewed credit growth. This across-the-board strength has no doubt driven the incredible returns of the market this year.

Where to from here? The case for further strength in equity markets is a relative one; absolute valuations look pretty stretched across the board. However, we note the ASX200 is yielding a dividend yield of 3.9%, making it the third-highest-yielding equity market in the world. To us, this offers compelling value vs the RBA cash rate of 0.1%. We think FY22 could be a year of significant capital return for investors, with many ASX companies carrying surplus capital: banks, miners, retailers and many industrials have seen dramatic balance sheet improvements over the past 18 months.

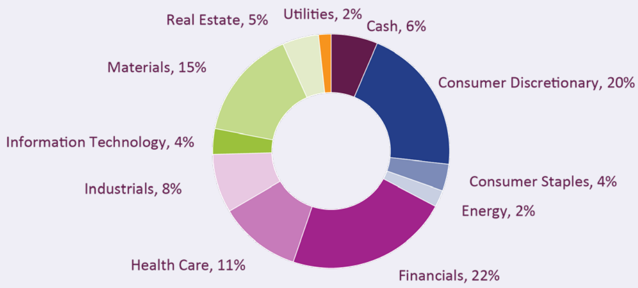
What worries us? As always, high starting valuations enhance the downside if things go wrong. Our two main concerns are inflation and China. Inflation is a worry because markets have risen over the last decade as discount rates have fallen. Take our earlier argument regarding the relative attractiveness of a 3.9% average dividend yield. If the cash rate rose to 3%, suddenly a 3.9% dividend yield isn't so attractive. However, we remain sceptical that the mountain of household debt on which Australians sit could sustain a 3% cash rate. This would represent a 1.5x increase in mortgage repayments, an enormous drag on household balance sheets. We believe a smaller interest rate hike in response to persistently high inflation would be effective in slowing demand (and prices). Worsening diplomatic relations with China also remain a concern, particularly for iron ore producers. It goes without saying: trade wars are bad for everyone.

PORTFOLIO POSITIONING

Top-10 holdings at 30 June 2021

Security	Weight (%)
Commonwealth Bank of Australia	7.3
BHP Group Ltd	5.7
CSL Ltd	5.6
National Australia Bank Ltd	4.4
Aristocrat Leisure Ltd	4.2
PWR Holdings Ltd	4.1
Wesfarmers Ltd	3.9
Mineral Resources Ltd	3.7
Healius Ltd	3.4
Macquarie Group Ltd	3.2
Total	**45.5**

Sector exposure[2]



As bottom-up stock-pickers, we invest on company fundamentals: seeking conservative balance sheets, businesses that generate good returns and are managed by competent people. However, from a top-down perspective we want to avoid "unintended bets"; i.e., positioning the portfolio in a way that leaves it vulnerable to certain macro events playing out. The key macro event to watch this year is inflation. There is no doubt in the near term that inflation will continue to increase: most of the companies we speak to are seeing significant input cost (and increasingly labour) inflation, and have signalled their intent to pass this on in the form of higher prices. Since we think inflation is heading up in the near-term, it's important to make sure our portfolio owns businesses with pricing power, that can protect margins and pass on higher costs to end consumers. We have analysed our portfolio through this lens and think we are well positioned. Businesses like James Hardie, Woolworths, Wesfarmers, Macquarie, the banks, Aristocrat and CSL should all benefit from (or at least not suffer from) higher inflation.

We also want to make sure we have avoided parts of the market that are priced as though interest rates can never rise, which for us includes most infrastructure businesses, loss-making tech companies and many high PE "structural growth" stories. These parts of the market have been big beneficiaries of falling rates as discount rates have come down, and we now think their valuations look vulnerable in the short term. However, given the high-quality nature of some of these businesses, we are hopeful that a short-term inflation induced sell off might throw up some interesting opportunities for us!

With respect to stock selection for the portfolio, we weigh four factors when considering an investment:

1. **Financial strength**: We want to own businesses with conservative levels of gearing and strong cash flows. While corporate balance sheets are in great shape across the board, with average net debt to EBITDA for ASX200 companies of 1.8x (well below the 10-year median of 2.5x), our portfolio has an average net debt to EBITDA of 0.3x. Further, 38% of our portfolio companies are in fact net cash. We believe this sets us up for strong future returns, whether through dividends, special dividends, buybacks, investment or acquisitions.

2 **Business quality**: We focus on businesses that can generate good or improving returns on their invested capital (ROIC). The reason is simple: higher returning businesses require less reinvestment to grow earnings, so more cash is available for shareholders. We believe a business can only sustain a high ROIC over the medium term if it has something special: barriers to entry, pricing power, favourable industry structure and/or a strong product that resonates with customers. When you invest in the ASX200 index, the median pre-tax ROIC is 14% (this excludes financials and REITs). By contrast, the pre-tax ROIC of our portfolio (ex financials and REITs) is 20%. This reflects our process, which selects for high (or improving) ROIC companies.

3 **Management quality**: We look for alignment with shareholders, whether that be through significant management shareholdings, or appropriate long-term incentives. The ultimate model of alignment for us is owner-managed businesses, where the original founder remains in control. We believe these businesses tend to outperform over the long term, and owner-managed businesses comprise c30% of our portfolio, compared to 10% of the ASX200.

4 **Valuation**: We believe the returns a business generates drive the value of the business, and seek to invest where the above factors are underappreciated in the prevailing market share price.

Matt Williams **Emma Fisher**

Performance as at 30 June 2021 [2]

	1 year (%)	3 years (% p.a.)	Since inception (% p.a.)
Airlie Australian Share Fund (ASX Ticker: AASF)	**33.7**	**12.1**	**13.3**
Banchmark (S&P/ASX 200 Accum. Index)	**27.8**	**9.6**	**10.5**
Excess	**5.9**	**2.5**	**2.8**

1 Based on GICS Sector classification, may not sum to 100% due to rounding.
2 Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD. Fund inception date:1 June 2018.

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