

FIRETRAIL ABSOLUTE RETURN FUND

MONTHLY REPORT | JUNE 2022

PERFORMANCE (AFTER FEES)

	Month	Quarter	6 Months	1 Year	2 Years p.a.	3 Years p.a.	Fund inception p.a. ²	5 Years p.a.	Strategy inception p.a. ⁴
Fund ¹	(3.59%)	(5.53%)	(9.69%)	(7.78%)	3.92%	7.42%	2.97%	-	-
Strategy composite ³	(3.59%)	(5.53%)	(9.69%)	(7.78%)	3.92%	7.42%	-	4.43%	9.28%
Benchmark	0.06%	0.10%	0.12%	0.17%	0.16%	0.33%	0.68%	0.78%	1.03%
Excess Return	-3.65%	-5.62%	-9.81%	-7.95%	+3.76%	+7.09%	+2.29%	+3.65%	+8.24%

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

30 JUNE 2022

Top 3 Overweight Holdings (Alphabetical)
Newcrest Mining
QBE Insurance Group
Santos

FUND DETAILS

Unit Prices ¹	30 June 2022
Application price	\$ 1.1344
Redemption Price	\$ 1.1264
NAV Price	\$ 1.1304
Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception date	14 March 2018
Fund size	\$350mil
Management fee*	1.50% p.a.
Performance fee*	20% of outperformance above an annual Hurdle

¹Please note, prices listed above are inclusive of distributions. Prices excluding distribution will be updated when they become available

*Please read the Product Disclosure Statement for more details

FUND EXPOSURE

30 JUNE 2022

	Portfolio Exposure
Long Equity	161.1%
Short Equity	-161.0%
Net Equity Exposure	0.1%

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/>.

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.

PORTFOLIO COMMENTARY

The Fund returned negative 3.59% for the month of June, underperforming the RBA Cash Rate by 3.65%. For the quarter ending 30 June 2022, the Fund returned negative 5.53%, underperforming the RBA Cash Rate by 5.62%.

It was a disappointing finish to a challenging financial year for Fund performance. Despite the challenging short-term performance, we remain confident in the outlook for the Fund to achieve our internal investment objective of outperforming the RBA Cash rate by 7% over the medium-term (3 years).

Looking at the past 3 years, the Fund has delivered 7.42% p.a. after fees, outperforming the RBA Cash Rate by 7.09% p.a. Over the same period, the ASX 200 returned 3.34% p.a. with significantly higher volatility than the Fund.

CONTRIBUTORS TO RETURNS

The long portfolio detracted from performance over the quarter and financial year to 30 June 2022. Australian small caps underperformed large caps by around 12% over the year. The portfolio's exposure to small caps dragged on returns for the period. The major underperformers in our small cap exposure were technology stocks that sold off heavily due to rising rates.

The short portfolio contributed positively to returns over the period. However, it was not enough to offset underperformance in the long portfolio.

NEGATIVE CONTRIBUTORS

Megaport

Megaport was negatively impacted by the sell-off in growth companies and missed sales expectations in the previous quarter. Megaport has recently moved its sales model to 3rd party distribution via some of the world's largest B2B technology businesses such as Cisco. Previously, all Megaport sales were done by their internal sales team. Over the medium to long-term, we believe there is significant value in Megaport leveraging the sales resources of the world's largest technology companies. However, it has resulted in some short-term disruption, at a time where any growth company that misses expectations has been sold off materially. The Fund has added capital to the Megaport position on the back of the share price weakness and our conviction in the medium-term outlook for the company.

Airtasker

Airtasker underperformed in the recent sell-off of growth and technology companies. Airtasker also completed an acquisition and capital raise to purchase local services platform OneFlare in May. Expanding their range of local services in Australia across their network.

Newcrest Mining

Newcrest underperformed on the recent gold price decline and cost increases across gold peers such as Evolution Mining. In the past month, Evolution flagged 5-6% labour inflation, but it was the increased cost of diesel and substantial ramp up in East Coast power prices that were the major drivers. We understand Newcrest's East Coast power contract prices are fixed until sometime next year. Whilst the position in Newcrest has cost the portfolio, our short positions in other gold names have somewhat offset the impact of gold underperforming as a sector.

POSITIVE CONTRIBUTORS

Tabcorp

Tabcorp completed the demerger of its Lotteries and Wagering divisions that resulted in price discovery and value creation for shareholders. Tabcorp Wagering was further buoyed by the NSW Government decision to increase the Point of Consumption Tax from 10% to 15% for wagering operators, which followed a similar decision in QLD. The changes further level the playing field between Tabcorp and the Corporate bookmakers.

QBE Insurance

QBE outperformed as fixed income yields continued to move in its favour. 3-year Government bond yields across US/UK/Australia moved up another ~30bps in June. After a slow start, the North American crop season made a late catch-up, reducing the risk of late planting claims in QBE's Crop business.

Ampol

The Ampol share price rose as margins in its refining business continued to benefit from the dislocation in energy markets. Benchmark refining margins have been running at above US\$30/bbl versus long-term levels of US\$8/bbl, increasing the chances of a material off-market buyback at the end of the calendar year.

PORTFOLIO POSITIONING AND OUTLOOK

The team have been highly active over the past 6-months to take advantage of the recent market volatility. Key portfolio changes include:

- **Reduced small cap technology exposure** – Since December 2021, we have been reducing exposure to technology companies that have not adapted to an environment of higher interest rates and higher costs. There is now reduced investor appetite to fund long-dated growth with limited visibility of profitability and future cashflows. We retain exposure to high quality companies with strong growth and forecasted future earnings such as Megaport and Aroa Biosurgery.
- **Increased exposure to oversold, profitable growth companies** – We have used the recent sell-off to increase exposure to profitable growth companies we believe have been oversold. Key examples include CSL, ResMed, Aristocrat Leisure and SEEK.
- **Marginally reduced exposure to resources** – Where we have taken profits in outperformers and reduced exposure to companies with risks to earnings due to higher costs.
- **Increased our fundamental shorts** – To take advantage of opportunities where earnings expectations are too optimistic, costs are rising faster than expected, inventory build is too high in a slowing economy, or higher debt servicing costs are not being factored into market expectations.

Current portfolio positioning can be summarised as:

- **Long energy** – Santos and Origin Energy. Based on our deep research that points to higher energy prices for longer due to underinvestment in supply.
- **Long globally-exposed financials** – QBE Insurance and Virgin Money UK. Positively exposed to higher rates but are trading at attractive valuations.
- **Long market leaders** – CSL, ResMed and James Hardie Industries. Trading on attractive valuations with underappreciated growth over a 3-year horizon.
- **Long small companies** – Select exposure to small companies that we believe are materially undervalued with earnings upside.
- **Short bond proxies, consumer staples, and domestic cyclicals** with high risk of earnings downgrades.

The portfolio remains market neutral (long portfolio exposure offset by short portfolio), to ensure returns are uncorrelated to equity market direction.

We have high conviction in the outlook for the portfolio over the next 12-24 months. Typically, portfolio performance has been strong post short-term periods of underperformance. With the current long and short opportunities on offer and our positioning, we are excited about the prospects for the Fund over the medium-term.

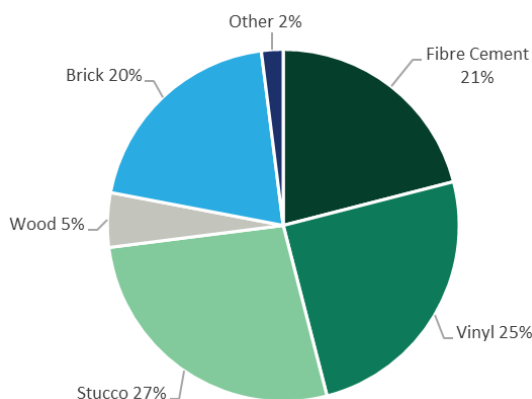
JAMES HARDIE DEEP DIVE – A DIFFERENT HOUSING CYCLE

In this report we will focus on James Hardie Industries, a stock the Firetrail Absolute Return Fund holds and a position we have recently increased. James Hardie is a global provider of fibre cement siding products, a material more durable than wood, with better aesthetics than Vinyl and more cost effective than brick.



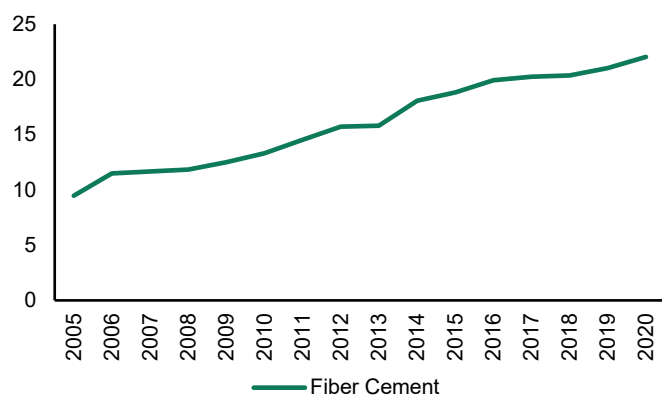
Fibre cement is a popular exterior product in North America, Australia and Europe. The majority of James Hardie’s products are sold in the US where Fibre Cement has a 22% share of the exterior siding market, up from <10% in 2005.

Figure 1: North America annual share of exterior siding installs



Source: Census Bureau, Firetrail

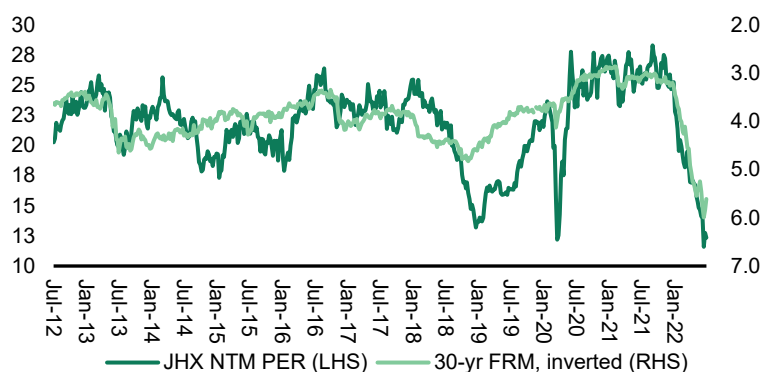
Figure 2: Fibre cement share of annual US external cladding installations (%)



Source: Census Bureau, Firetrail

James Hardie’s share price has retraced significantly since the start of 2022 due to rising interest rates. Investors associate rising rates with the end of housing cycles because higher borrowing costs dampen willingness for consumers to take on more debt. As a result, less houses are built, and there is less demand for related goods such as building materials, building products, fixtures and fittings. The added possibility of recession will further deepen any downturn.

Figure 3: James Hardie P/E ratio vs US 30-year fixed mortgage rates (% , inverted)



Source: Census Bureau, FactSet, Firetrail

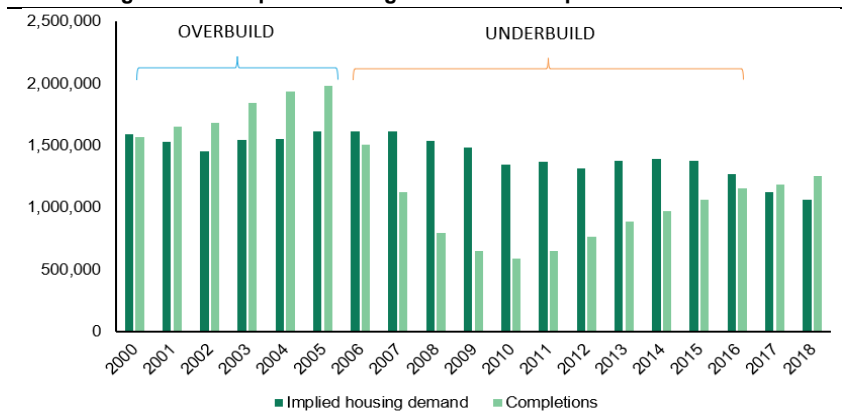
In speculating on a potential housing downturn, media coverage often compares the current cycle to what followed the 2007-08 Global Financial Crisis. The post-GFC housing downturn was particularly tough in the US, which saw a peak to trough decline of 70% in new housing starts over 2008-12. However, the GFC was very different to the current environment and shouldn't be used as a comparison.

Some key differences between the GFC and the current environment include:

1. Chronic underbuild

Scarring from the GFC resulted in 12 years of significant housing underbuild in the US. We estimate that annual US housing demand is around 1.5 million units based on population growth, housing formation and replacement rate. Due to the underbuild post-GFC, we estimate the US needs an additional 4-4.5 million homes that just haven't been built.

Figure 4: US implied housing demand vs completions since 2000

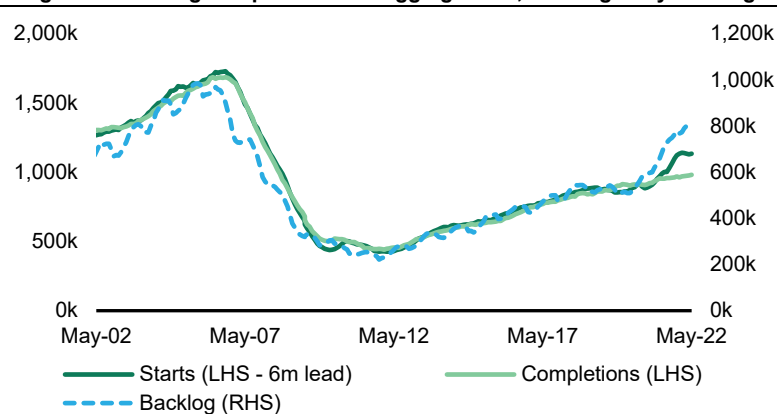


Source: Census Bureau, Firetrail

2. Construction backlogs

Strong housing demand coupled with supply constraints over the past 2 years have created a significant backlog of construction work. The construction work backlog will keep demand for building materials elevated until worked through. We estimate the current backlog amounts to 180,000 new homes where construction has started but is still incomplete. It is unlikely this backlog will be completed until 3Q or 4Q of 2023.

Figure 5: Housing completions are lagging starts, creating hefty backlogs

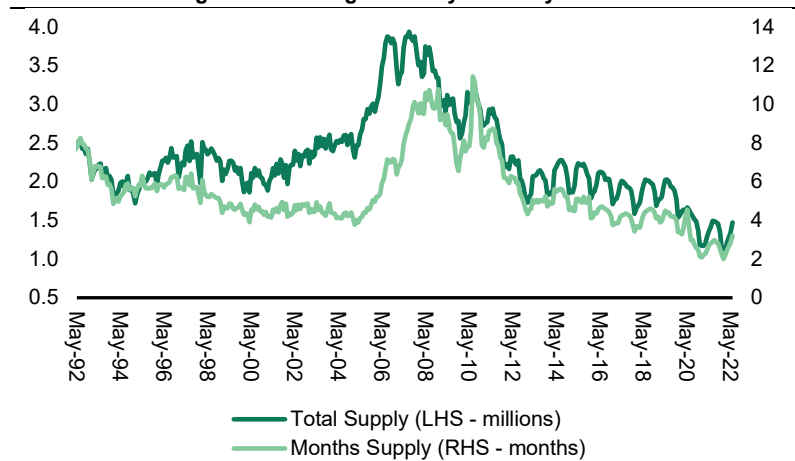


Source: Census Bureau

3. The stock of homes available remains low

Leading up to the GFC, we saw a significant overbuild of homes. Housing inventory swelled to over 12 months of supply at the peak in 2010. In contrast, housing inventory today is just 3 months of supply due to the chronic underbuild of homes over the past decade.

Figure 6: Housing inventory is at 30-year lows

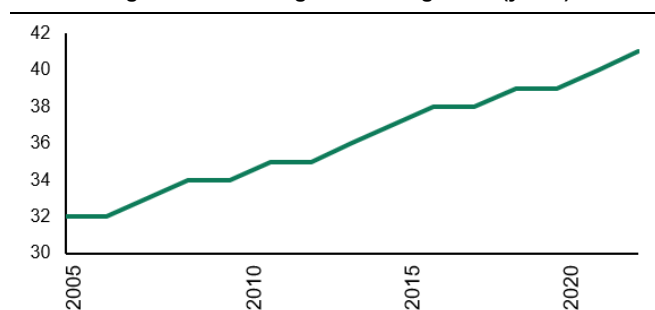


Source: Census Bureau, Firetrail

4. US houses are old. Really old...

The median age of a house in the US has increased from 32 years old pre-GFC to over 40 years old today. The ageing housing stock is positive for new housing demand, and also positive for repair and renovation demand.

Figure 7: Median age of housing stock (years)

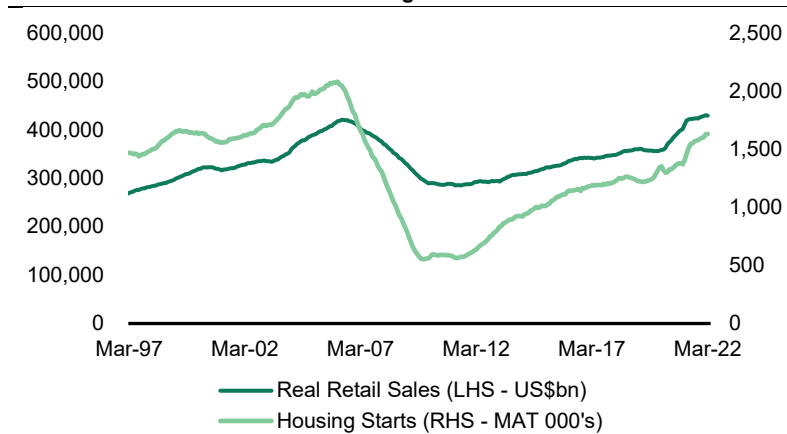


Source: Census Bureau, Firetrail

James Hardie is now more exposed to renovations versus new home construction

All housing stocks are not created equal. Fortunately for James Hardie, about 65-70% of its revenue comes from repair and renovations activity. However, James' Hardie's stock price trades very closely with new home builders in the US. Repair and renovations spending has historically been less volatile and less cyclical than new housing construction. This is illustrated in Figure 8 below.

Figure 8: Repair and renovations sales are much less volatile than new housing starts



Source: Census Bureau, Firetrail

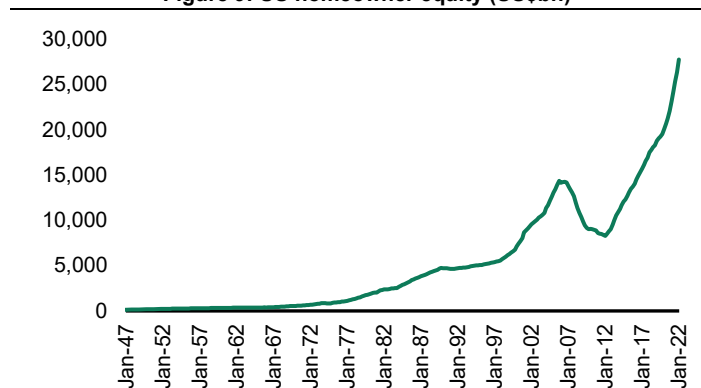
Repair and renovations spending fell just 20% from peak-to-trough during the GFC, while new housing starts suffered a 70% decline.

So, how are repair and renovation lead indicators tracking today?

1. Home equity is at an all-time high, and nearly 2x that of pre-GFC.
2. Mortgage stress is at all-time lows.
3. Existing home sales are falling as higher rates reduce mobility meaning increased willingness to spend on the current home.

These factors are likely to mean a much shorter and shallower downturn for housing this time around compared to the post-GFC housing cycle.

Figure 9: US homeowner equity (US\$bn)



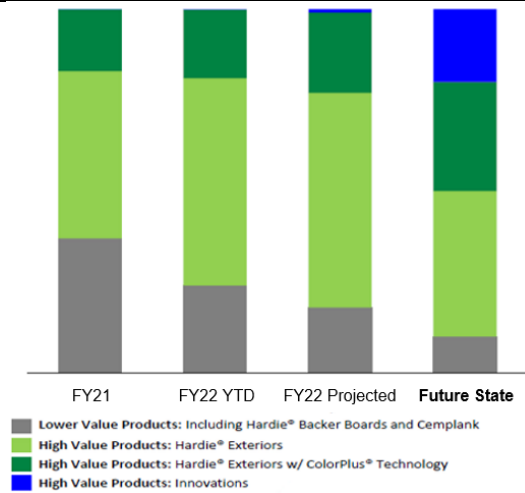
Source: Census Bureau, Firetrail

Focus on the long-term margin prize

James Hardie's strategy over the last 2 years has been to pivot from being a supplier of building products to builders/contractors, toward being a more brand-centric consumer business. It is focusing on increasing brand awareness directly with consumers, and it's working!

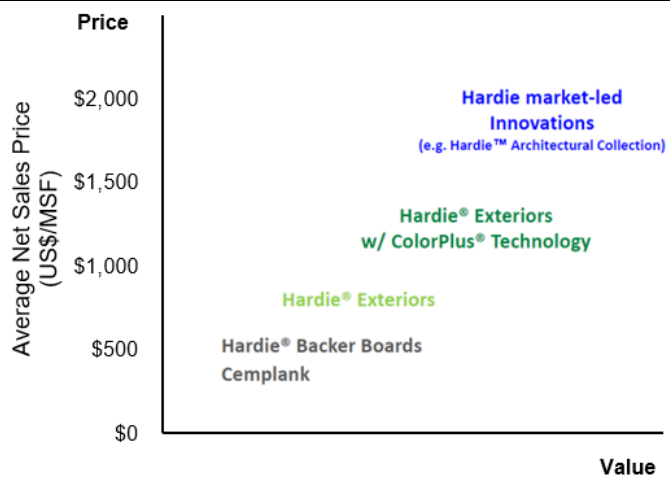
Figure 10 below highlights the change in James Hardie’s sales mix over the last 2 years towards higher value products.

Figure 10: James Hardie North America volume mix



Source: James Hardie

Figure 11: James Hardie - North America price/value matrix

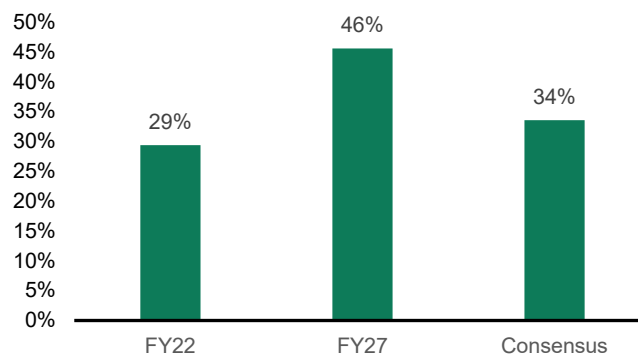


Source: James Hardie

Figure 11 illustrates the difference in pricing for these higher value products. While pricing is higher for higher value products, the cost to produce them is similar to the cost to produce lower value products. This implies material margin upside if James Hardie can continue to shift product mix towards its long term “Future State” target in Figure 10. We estimate that North America margins of 29% could increase to over 45% if the “Future State” product mix is achieved and 30% of profit is reinvested.

The consumer strategy highlights the earnings prize on offer if James Hardie can execute and convince homeowners to pay up for higher value products.

Figure 12: EBIT margin assuming 30% of uplift is reinvested



Source: Firetrail

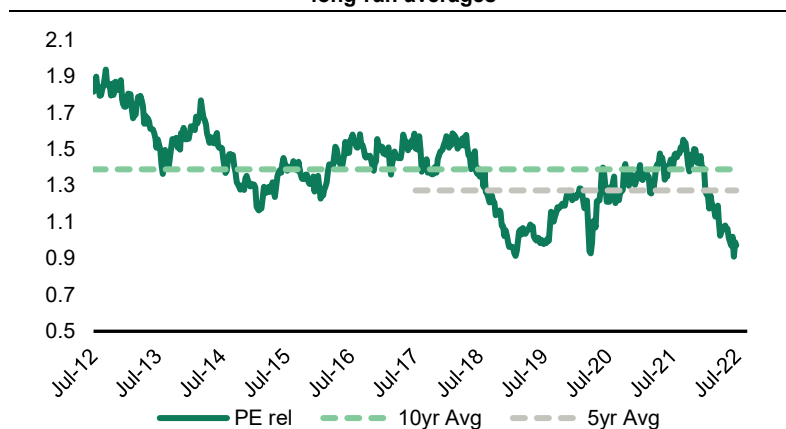
Valuation looks attractive

At Firetrail, we believe it’s important to understand what market expectations are implied by the current share price. Over the past 6 months, James Hardie shares have derated from a 50% premium to market to a slight discount. Over the past decade, James Hardie’s forward P/E ratio has averaged 22x. It is currently just 12x.

Using the historical average, the market is implying James Hardie will earn US\$1.05 per share of EPS in FY24 against consensus forecast EPS of US\$1.82 per share. In other words, the market is expecting a 40% downgrade to FY24 earnings. We believe this is harsh given the housing market appears to be on a more sustainable footing compared to the GFC in 2007-08.

The material product mix and margin opportunity on offer for James Hardie gives us further confidence in the earnings profile, suggesting the current market dislocation and de-rating presents a compelling opportunity over the medium term.

Figure 13: James Hardie P/E ratio relative to ASX 200 P/E ratio, relative to long-run averages



Source: Factset, Firetrail

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

In late June, it was reported that a large rare earths deposit had been found in Turkey.

The share price of Lynas Rare Earths, a holding in the Firetrail Absolute Return Fund, was negatively impacted by the news. Lynas' key rare earth mineral, NdPr, is a vital input for electric vehicles, wind turbines and a variety of other renewable energy applications. Demand for NdPr will grow significantly as the world transitions to renewables. In addition, supply is constrained, which means higher NdPr prices and higher revenues for Lynas.

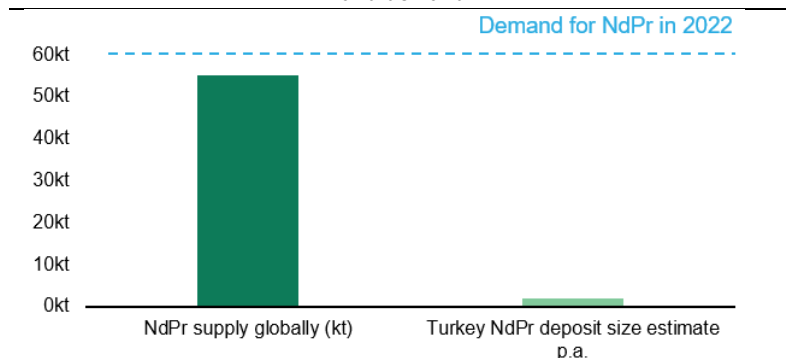
However, a large new deposit could change this supply/demand imbalance. Firetrail's Resources analyst conducted deep dive research to determine if the news out of Turkey is just noise, or if it indicates a material change to the supply of NdPr.

Once it is online, the Turkish deposit is expected to produce around 10,000 tonnes of rare earths per annum. Typically, NdPr will account for around 20% of a deposit like this, meaning approximately 2,000 tonnes of NdPr will be added to global supply.

To put this into context, global supply of NdPr was around 55,000 tonnes in 2022. Demand was over 60,000 tonnes in 2022, exceeding supply even after adding the new Turkish supply. On our forecasts, even if this deposit was to come online within 5 years, the NdPr market will remain in deficit until 2025-2026.

To sum up, this news is interesting, but it's not 'what matters' to the price of NdPr and rare earths producers like Lynas over the next few years.

Figure 14: The new Turkish NdPr deposit is small relative to global supply and demand



Source: Firetrail

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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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