

# FIRETRAIL ABSOLUTE RETURN FUND

MONTHLY REPORT | DECEMBER 2021

## PERFORMANCE (AFTER FEES)

	Month	Quarter	6 Months	1 Year	2 Years p.a.	3 Years p.a.	Fund inception p.a. <sup>2</sup>	5 Years p.a.	Strategy inception p.a. <sup>4</sup>
Fund <sup>1</sup>	-2.03%	-0.23%	2.12%	3.75%	11.34%	9.08%	6.17%	-	-
Strategy composite <sup>3</sup>	-2.03%	-0.23%	2.12%	3.75%	11.34%	9.08%	-	6.68%	11.87%
Benchmark	0.01%	0.03%	0.05%	0.10%	0.21%	0.53%	0.73%	0.90%	1.10%
Excess Return	<b>-2.04%</b>	<b>-0.26%</b>	<b>+2.07%</b>	<b>+3.65%</b>	<b>+11.12%</b>	<b>+8.55%</b>	<b>+5.44%</b>	<b>+5.78%</b>	<b>+10.77%</b>

## 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 DECEMBER 2021

Top 3 Overweight Holdings (Alphabetical)
Crown Resorts
Newcrest Mining
Santos

## FUND DETAILS

Unit Prices	31 December 2021
Application price	\$ 1.2561
Redemption Price	\$ 1.2473
NAV Price	\$ 1.2517
Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception date	14 March 2018
Fund size	\$396mil
Management fee*	1.50% p.a.
Performance fee*	20% of outperformance above an annual Hurdle

\*Please read the Product Disclosure Statement for more details.

## FUND EXPOSURE AT 31 DECEMBER 2021

	Portfolio Exposure
Long Equity	189.6%
Short Equity	-189.8%
Net Equity Exposure	-0.3%

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 Firetrail Absolute Return Fund returned -0.23% for the quarter ending 31 December 2021, underperforming the RBA Cash Rate benchmark by 0.26%. For the month, the Fund returned -2.03%, underperforming the benchmark by -2.04%.

Positive contributors to performance included long positions in Crown, Lynas and Oz Minerals.

Detractors included an overweight position in APM Human Services, Santos and Serko.

## WHAT'S DRIVING MARKETS?

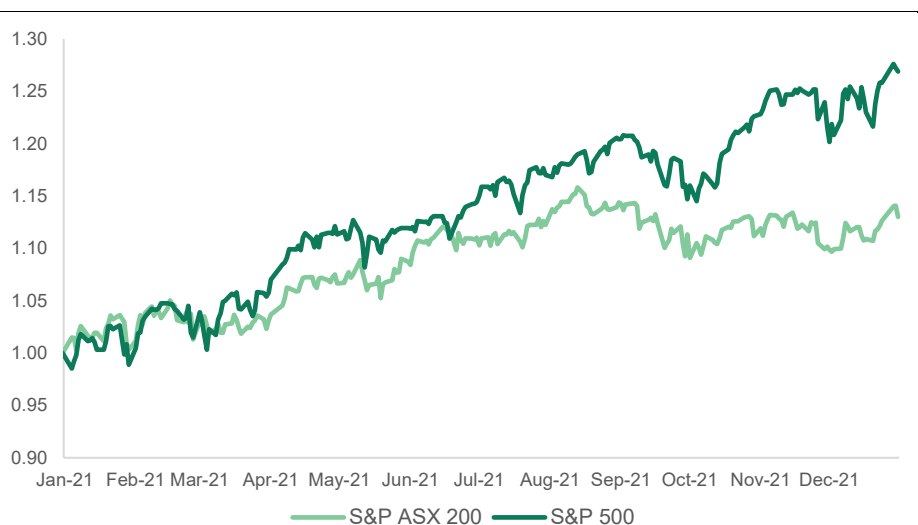
### That's a wrap - Equity markets end on a high!

The Australian market ended 2021 on a high, with the S&P/ASX200 index rising 2.5% in December as concerns around the severity of the Omicron variant subsided despite a surge in global cases. Iron ore rallied 20%, while Oil was up 10% signalling a better outlook for global growth. Heightened M&A activity continued with Virtus receiving a non-binding approach from BGH Capital. Link Group entered a binding arrangement with Dye & Durham for the takeover of all issued shares after the Board recommended shareholders accept the acquisition proposal.

Overall Aussie market gains were 13% (price) through the past 12 months with the index finishing the year around 5% above the pre-pandemic high seen in February 2020. Communication Services was our best performing sector, up 30% over 2021, driven by a c.40% increase in Telstra's price. Telstra remains a key overweight in the Firetrail Absolute Return Fund. Information Technology was the worst performing sector, falling 3% over the year.

In the US, the S&P500 finished up 4.5% in December and up 27% over the past 12 months. This was led by Energy and Real Estate. The S&P500 rounded out the year with traditional valuation multiples at or near highs not seen since the early-2000s despite forward 12-month earnings estimates pushing well above pre-pandemic levels. Australian valuation multiples have followed a similar path with the S&P200 12-month PE at its highest levels since the late 1990s.

Figure 1. The Australian market returned 13% (price) over 2021...



Source: FactSet, Firetrail December 2021

## WHAT THE FIRETRAIL TEAM IS EXPECTING IN 2022

The key themes driving markets in the new year have rarely been as clear as 2022. The four that we see dominating investors thinking are:

1. Inflation
2. Rising interest rates
3. A peak in corporate earnings, and
4. M&A

Covid adds complexity to how these themes will impact the market outlook through the year. We see the Firetrail Absolute Return fund as ideally positioned to capitalise on what appears to be a more challenging backdrop for markets as we near a cyclical peak in earnings and trough in the interest rate cycle.

**1. Inflation**

Strong recovery in demand growth in 2021 saw the unexpected arrival of inflation across major global economies. Inflation measures hit multi-decade highs. Initially these spikes were seen as transitory and impacted by Covid related supply chain disruptions. However, by November the US Fed Reserve was officially abandoning the “transitory” argument. Fed Reserve Chair Powell claimed it was difficult to predict how long supply issues would linger. Meanwhile the latest November CPI read surged 6.8%, its fastest rate since 1982.

The arrival of Omicron appears to be adding to global supply chain challenges. Port congestion, bottlenecks and delays, production disruptions and the slow return of labour supply will likely keep inflation pressures elevated in the coming months.

Meanwhile rising labour costs are also adding to inflationary pressures across many developed markets. In the US, labour force constraints saw wages growth jump to an annualised 5% in December. The US labour force has struggled to return to pre-pandemic levels with around 3.3m workers or 2% of the labour force not returning since the pandemic began.

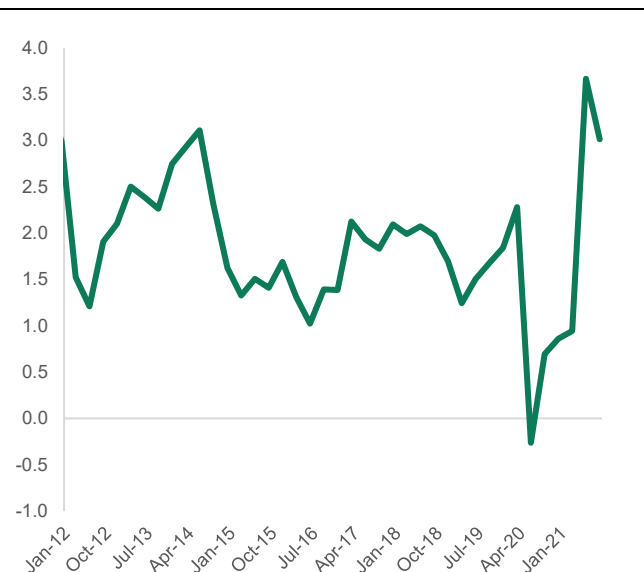
Inflation expectations are leading the debate within the Firetrail team and how we are thinking about interest rates (valuation multiples), the impact on corporate profit margins and growth in the coming year.

**Figure 2. US inflation (CPI, y/y% change)**



Source: Factset, Firetrail December 2021

**Figure 3. Australian inflation (y/y% change)**



Source: Factset, Firetrail December 2021

**2. Rising interest rates**

There is little doubt that we are past the trough of the current interest rate cycle. US bond yields are materially higher following rapid wage growth data and the Fed’s confirmation in December that it was ending its pandemic-era stimulus sooner than expected. The US 10-year breached 1.8% in early January representing a post-pandemic high. Odds for a March Fed rate hike have also increased to 90%, with four rises now expected through 2022 versus three previously. This is expected to continue over the next 2 years and end with a 10-year Fed rate of 2-2.5% by end-2024. The challenge will be to bring inflation under control without short circuiting the business cycle. If inflation does not moderate, this will trigger faster Fed hikes increasing the risks of a policy-driven recession.

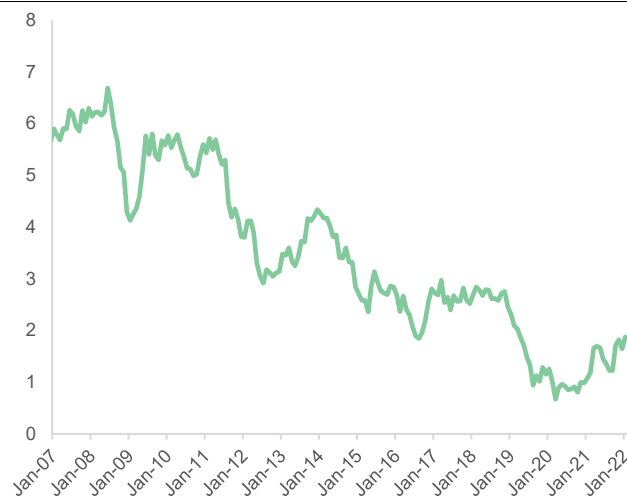
In Australia, the rate cycle appears to be a couple of quarters behind the US. The RBA has not officially announced the end of QE, albeit this appears imminent given higher inflation. Rate hikes are being priced in from the Dec-2022 quarter with supply chain bottlenecks and building wage pressures likely to persist through the year. The upcoming Federal election may cushion the tightening monetary backdrop via additional material fiscal stimulus, which could prolong solid demand conditions for corporate earnings over the near term.

**Figure 4. Australia 12-month forward PE valuations**



Source: Factset, Firetrail December 2021

**Figure 5. Australian 10-year yield (%)**

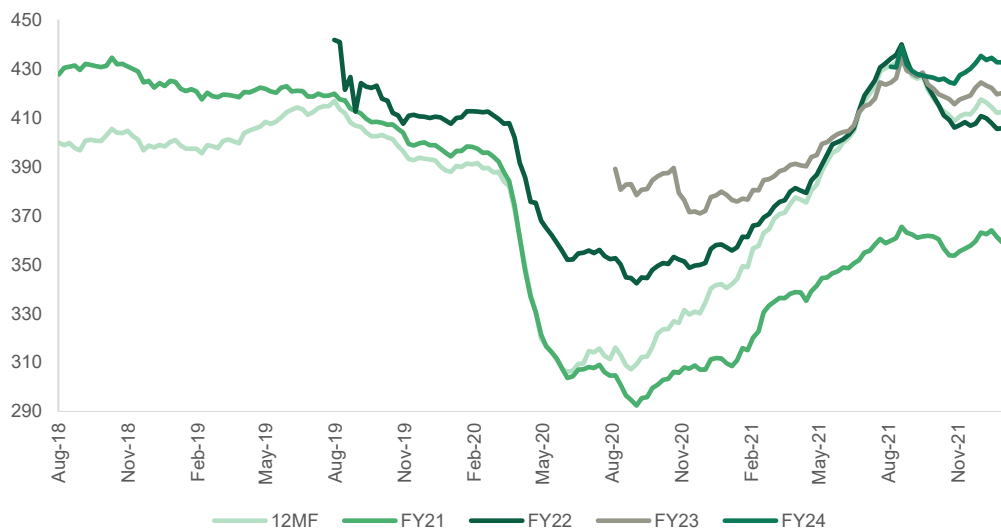


Source: Factset, Firetrail December 2021

**3. Peak Earnings**

A charging economy, low rates and a cashed-up consumer have combined to drive profit margins for corporate Australia towards peak levels. We expect the backdrop to remain generally supportive of earnings over the next 2-3 quarters. However, the rate of EPS growth will slow as inflationary imposts become harder for corporates to pass on. We have seen negative FY22 EPS revisions since August, suggesting the peak in earnings growth may already be behind us. A rising rate environment will further pressure margins. Previous hiking cycles have rarely ended well for corporate profits. We expect a more challenging backdrop for valuation multiples as markets try to price peak earnings towards the second half of 2022.

**Figure 6. FY21-24 Annual IBES consensus EPS revision trends**



Source: Morgan Stanley, Firetrail December 2021

#### 4. No slowdown in M&A

M&A activity will likely remain elevated again in 2022. If companies begin to see inflation as an underlying threat to profitability, they will likely dip into cash reserves or use elevated stock prices to pursue inorganic growth.

### PORTFOLIO POSITIONING FOR 2022

The Firetrail Absolute Return Fund closed slightly down for the December quarter. Investing in FARF requires a minimum 3 year timeframe. The fund has never underperformed on a rolling 3 year basis and we remain incredibly confident about the available prospects through FY22.

We currently see stocks leveraged to global growth and reopening providing greater opportunities overall. This is reflected in the Fund's value and cyclical tilt over more yield sensitive and growth sectors.

### PORTFOLIO CONTRIBUTORS & DETRACTORS

The Fund delivered a marginally negative return of -0.3% for the December quarter. Breaking it down:

- The **long portfolio** added +0.8% during the quarter – With the high conviction mid to large cap portfolio performing strongly. Marginally offset by events.
- The **short portfolio** detracted -1.1% during the quarter – With the risk shorts used to hedge equity exposure and thematic risk the predominant driver of underperformance in the short portfolio.

#### Some of the standouts from the December quarter included:

##### Crown Resorts

Crown was up 25% through the December quarter after receiving its third takeover proposal from Blackstone at \$12.50 cash per share. The bid is conditional and non-binding albeit less onerous than the two previous proposals. The renewed interest highlights the inherent value in the underlying real estate assets both owned and controlled by Crown. It also highlights the positive operating outlook driven by a broader re-opening of the Australian economy. Crown remains a key holding in the Firetrail Absolute Return Fund.

##### 29 Metals

29 Metals increased by 34% over the quarter. 29 Metals is a mid-tier copper and zinc producer with two operating assets. During December, zinc prices increased by ~8% as refined supply was reduced in response to rapidly rising electricity prices across Europe. Despite receiving less attention than commodities such as lithium, copper and zinc demand will also increase strongly from decarbonisation.

##### Lynas

Lynas rose 52% as the NdPr price (the most valuable component of Lynas's rare earth basket) continued to rise, up to ~USD\$130/kg. There was significant industry consolidation during the quarter in the Chinese rare earth sector that supplies over 80% of the global market. China Northern Rare Earth Group announced an agreement to 'co-operate' in mining, trade and processing operations with China Rare Earth Holdings. In addition, Chinese rare earths producers Minmetals Rare Earth, Chinalco Rare Earth and China Southern Rare Earth announced a 3-way merger. These developments highlight the strategic importance of Lynas's non-Chinese supply chain.

#### Key detractors in the quarter comprised

##### APM Human Services

APM shares were down 15% after the company's recent listing on the ASX. The company provides employment services to individuals who require support to find work, including those with injury, illness or disability. Despite the tough start we see a positive backdrop for APM, supported by strong demand for employment services, a fragmented market structure and the company's global capability to target an increasing pipeline of contracts. We see this providing APM with further consolidation opportunities.

**Santos**

Santos shares were down 12% in the December quarter, reflecting volatility in the oil price following the emergence of the Omicron variant in November. The company also completed the merger with Oil Search in the quarter following approvals. Overall, we maintain conviction in Santos, given its free cash flow profile, growth outlook and diversity of producing assets.

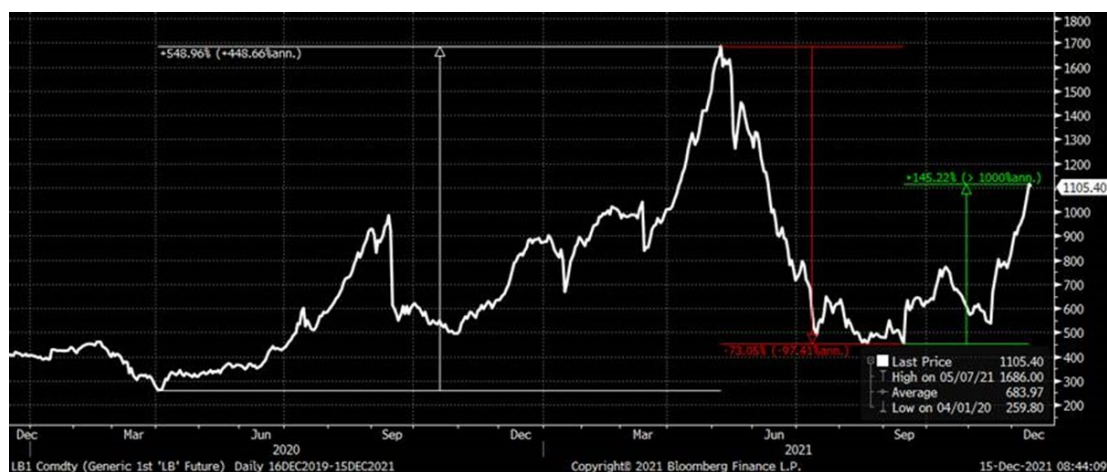
**Serko**

Serko declined by 22% in the quarter. This followed a weaker than expected earnings result, the emergence of Omicron and a fourth Covid wave, and a capital raising. Serko raised money to allow accelerated development in the Booking.com 'booking-for-business' partnership. We were disappointed with the timing of the capital raising. However, in our view, there is no higher returning investment in the market and subsequently increased our position during the month.

**ONE INTERESTING THING THAT HAPPENED THIS MONTH**

The timber price continued its bounce back this month! See the chart below showing US lumber prices, which is mainly used for framing houses.

**Figure 7. The US lumber price has been on an upward trajectory since mid November...**



Source: Bloomberg, Firetrail December 2021

The timber price increase has been on the back of the following factors:

- Increasing demand – the construction backlog continues to increase in the US. Despite the increased likelihood of interest rate hikes, the US homebuilder share price index exited 2021 at record highs and a 48% return over the year.
- Wood as a sustainable building material – there are now 18 storey high buildings made just from wood, no concrete or steel beams!
- Supply may start to get constrained as carbon prices increase – revenue is earned by storing carbon rather than harvesting for the wood.

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