

# FIRETRAIL AUSTRALIAN HIGH CONVICTION FUND

MONTHLY REPORT | SEPTEMBER 2022

## PERFORMANCE (AFTER FEES)<sup>1</sup>

	Month	Quarter	6 Months	1 Year	2 Years p.a.	3 Years p.a.	Fund inception p.a. <sup>3</sup>	5 Years p.a.	7 Years p.a.	10 Years p.a.	Strategy inception p.a. <sup>5</sup>
Fund <sup>2</sup>	(6.55%)	(1.68%)	(14.29%)	(10.95%)	10.81%	3.62%	3.31%	-	-	-	-
Strategy composite <sup>4</sup>	(6.55%)	(1.68%)	(14.29%)	(10.95%)	10.81%	3.62%	-	4.43%	8.40%	11.10%	8.67%
Benchmark	(6.17%)	0.39%	(11.56%)	(7.69%)	9.78%	2.67%	5.96%	6.79%	6.88%	9.27%	6.53%
Excess Return	<b>-0.37%</b>	<b>-2.07%</b>	<b>-2.72%</b>	<b>-3.27%</b>	<b>+1.03%</b>	<b>+0.95%</b>	<b>-2.64%</b>	<b>-2.36%</b>	<b>+1.52%</b>	<b>+1.83%</b>	<b>+2.14%</b>

1. Past performance is not indicative 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.

## AUSTRALIAN HIGH CONVICTION FUND

The Australian High Conviction Fund ("Fund") is a concentrated portfolio (approx. 25 companies) of our most compelling equity ideas. 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 ASX 200 Accumulation Index over the medium to long term (after fees).

## PORTFOLIO POSITIONING - 30 SEP 2022

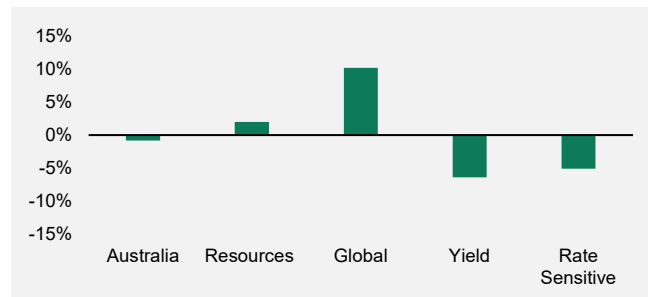
Top 3 Overweight Holdings (Alphabetical)
Newcrest Mining Ltd
ResMed Inc
Santos Ltd

## FUND DETAILS

Unit Prices	30 September 2022
Application price	\$ 1.0678
Redemption Price	\$ 1.0646
NAV Price	\$ 1.0662
Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Risk/Return Profile	High
Number of Holdings	24
Fund size	\$626mil
Management fee*	0.90% p.a.
Performance fee*	15% of outperformance above an annual Hurdle

\*Please read the Product Disclosure Statement for more details

## THEMATIC POSITIONING - 30 SEP 2022



Source: Firetrail. Relative to the Benchmark

Past performance is not a reliable indicator of future performance.

The Product Disclosure Statement ('PDS') and the Target Market Determination ('TMD') of the Fund is available at [www.firetrail.com](http://www.firetrail.com). Any potential investor should consider the PDS and TMD before deciding whether to acquire, or continue to hold units in, the Fund.

2. Firetrail Australian High Conviction 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 Australian High Conviction Strategy Composite ('Strategy') which has been operating since 29 November 2005. 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 High Conviction Fund (after fees) between 29 November 2005 to 23 November 2017. The Fund employs the same strategy as was used by the same investment team that managed the Macquarie High Conviction Fund as at 23 November 2017. Firetrail has records that document and support the performance achieved as the Macquarie High Conviction Fund. The composite returns for the Strategy and the S&P/ASX 200 Accumulation Index (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 29 November 2005.

## PORTFOLIO COMMENTARY

The Fund returned negative 6.55% (after fees) for the month ending 30 September 2022, underperforming the ASX 200 Accumulation Index by 0.37%.

For the quarter ending 30 September 2022, the Fund returned negative 1.68% (after fees), underperforming the ASX 200 Accumulation Index by 2.07%

## CONTRIBUTORS TO RETURNS<sup>1</sup>

Positive contributors included ResMed, Australia and New Zealand Banking Group and CSL. Negative contributors included Virgin Money UK, Origin Energy and Santos. We discuss each further in our commentary below.

### POSITIVE CONTRIBUTORS

#### ResMed

ResMed outperformed in September as management continued to guide to a gradual easing of supply chain pressures. In addition, ResMed's main competitor, Philips, was the subject of another product recall initiated by the US Food and Drug Administration. Roughly 17 million masks manufactured by Philips were found to have magnets that did not meet FDA safety standards.

#### Australia and New Zealand Banking Group (ANZ)

ANZ outperformed the ASX 200 in September and was also the best performer of the major banks. There was no company specific news, however broker surveys and APRA mortgage data indicated that ANZ continues to close the gap to peers on mortgage processing turnaround times.

#### CSL

CSL outperformed alongside most other healthcare stocks in September. The market favoured businesses like CSL, with more defensive earnings profiles, during the month.

### NEGATIVE CONTRIBUTORS

#### Virgin Money UK

Virgin Money UK underperformed during the month post the release of the UK Government's mini-budget. While the budget contained positive measures to support consumers and businesses, the degree of spending sparked fears that the resultant inflation would drive more aggressive central bank tightening. In our view, Virgin Money UK's substantial surplus capital position and conservative lending portfolio put it in a strong position to weather a period of tougher economic conditions.

#### Origin Energy

Increased fears of a global recession led to a selloff in oil during September. The Brent crude price fell 9% to US\$88 per barrel. Origin underperformed as the cash flows from its Asia-Pacific LNG project are linked to the oil price. Origin's Energy Markets division is also negatively leveraged to lower energy prices due to fixed price contracts for gas and renewable inputs.

#### Santos

Santos was also negatively impacted by the oil price decline, underperforming the market. Santos confirmed that the PNG Government has submitted an offer to acquire an additional 5% interest in PNG LNG from Santos for an asset value of US\$1.4bn. Santos has until 31 December 2022 to accept the offer, which would reduce its ownership interest to 37.5%.

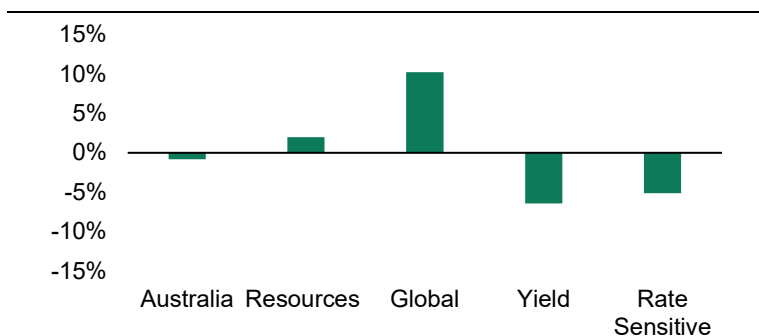
## PORTFOLIO POSITIONING

With underweight positions in Yield and Rate Sensitive categories broadly offsetting each other, our main thematic exposure is an overweight holding in global stocks. Our positioning across each category can be summarised as follows:

- **Australia:** overweight cyclicals with strong market positions like Qantas Airways and SEEK, and defensives like The Lottery Corporation. Underweight consumer staples.
- **Resources:** overweight energy and decarbonisation metals through exposure to Santos and Lynas Rare Earths. Underweight iron ore.
- **Global:** holdings in companies that either have robust demand profiles like ResMed and CSL, or businesses that are priced too cheaply for their reality, like James Hardie Industries and Lendlease.
- **Yield:** overweight gold through our holding in Newcrest Mining. Underweight real estate and infrastructure stocks.
- **Rate Sensitive** – overweight QBE Insurance and Virgin Money UK. Underweight Aussie banks.

<sup>1</sup> Illustrative only and not a recommendation to buy or sell any particular security

**Figure 1: Firetrail High Conviction Fund thematic risk exposures (relative to benchmark) – 30 September 2022**



Source: Firetrail

Material changes made to the portfolio over the September quarter included:

- Exited positions in Aristocrat Leisure, OZ Minerals, Tabcorp Holdings and Telstra Corporation
- Increased position sizes in CSL, Newcrest Mining and The Lottery Corporation
- Reduced position sizes in Nufarm, QBE Insurance and SEEK.

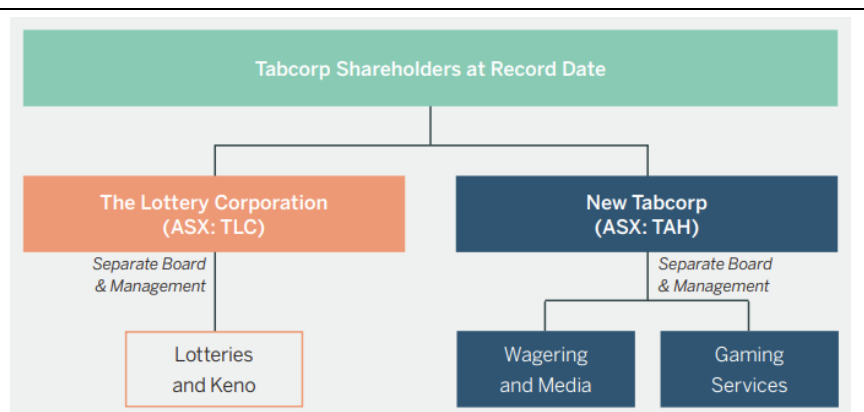
The portfolio remains highly concentrated with 75% active share and 60% stock-specific risk.

## THE LOTTERY CORPORATION<sup>2</sup> DEEP DIVE

On 23rd May 2022, the old Tabcorp business was demerged into two entities: 1) the wagering and media arm which retained the Tabcorp name, and 2) the lotteries and keno arm which is now named The Lottery Corporation (TLC).

Post the demerger, we increased the size of our position in The Lottery Corporation. It is one of the core defensive holdings in the Firetrail High Conviction Fund.

**Figure 2: In September, Tabcorp was demerged into two separate entities**



Source: Tabcorp

### Demerger creates a more focused business

In the right circumstances, we believe demergers have the potential to create substantial value for shareholders. There are three key areas where value can typically be unlocked, namely:

1. Improved management focus on a single set of strategic priorities.
2. Access to cash flow stream for distribution to shareholders or reinvestment in the business (in the case that cash flows were previously being diverted to other parts of the group).
3. Opportunity for removal of corporate overheads.

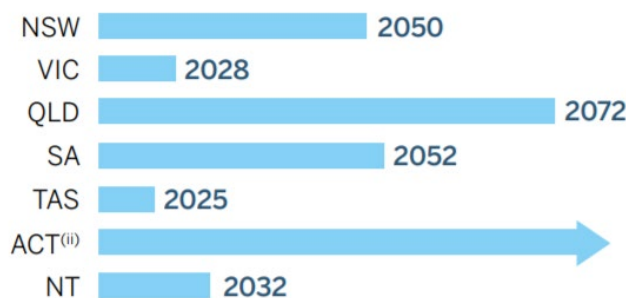
<sup>2</sup> Illustrative only and not a recommendation to buy or sell any particular security

The Lottery Corporation was responsible for ~60% of old Tabcorp’s earnings, however given the challenges faced by the wagering division we believe Lotteries wasn’t receiving a commensurate share of management attention or strategic focus. With a dedicated management team and capital framework now in place, we believe The Lottery Corporation is now set up to deliver strong returns for shareholders over the medium-term.

**Long-term revenues offer growth and defensiveness**

The Lottery Corporation holds long-term exclusive licenses to operate lotteries in every state and territory of Australia. Victoria is the only major state licence that is up for renewal before 2050. We expect the company to ultimately extend the Victorian licence beyond 2050, most likely years before the 2028 expiry date approaches.

**Figure 3: TLC has long-term, exclusive lottery licenses across Australia (License expiry dates for each state/territory)**



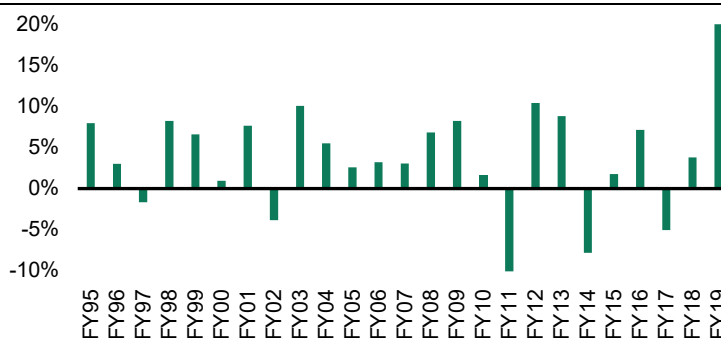
Source: Tabcorp

The Lottery Corporation’s revenues are primarily driven by:

- Population growth and demographics.
- Engagement of player base through digital offering.
- Changes to pricing and game structures.

Australian lottery revenues have grown at an average rate of 3.8% over the past three decades. There is some year-to-year variability owing to the randomness of jackpot sequences. However, over the last three decades, revenues have not gone backwards over any three-year rolling period. More importantly, revenues have shown resilience through periods of softer economic growth. During the GFC, revenues grew 7% in the year to June 2008, and another 8% in the year to June 2009.

**Figure 4: Annual Australian lottery revenue growth since 1995**

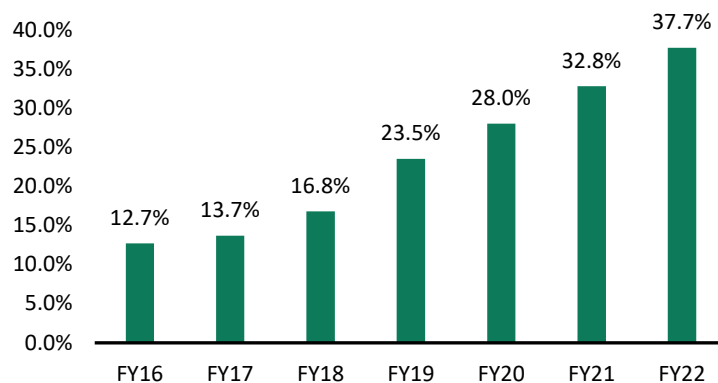


Source: Queensland Treasury

The increasing role of the digital channel has been a feature of Tabcorp’s lotteries results for many years now, but this trend accelerated through COVID. The convenience of access to playing via ‘The Lott’ app has increased the penetration of lotteries in younger demographics, and also increased engagement with existing retail customers.

The Lottery Corporation has found that, on average, existing retail customers increase spend by 52% after they join the digital platform. Given less commission is paid away to channel partners when customers use the digital platform, increased digital penetration is also accretive to gross margins.

**Figure 5: % of lottery turnover through digital channel**



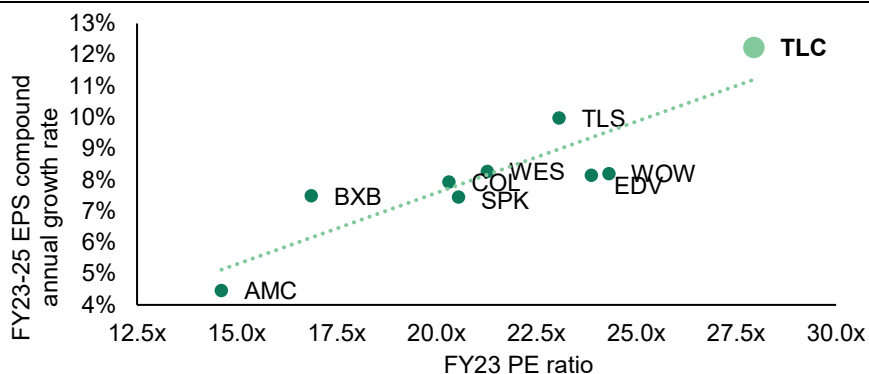
Source: The Lottery Corporation

**Capital framework and valuation**

The Lottery Corporation begins its life as a listed entity with what we believe is a very conservative capital framework. Net debt / EBITDA currently sits at 3.1x versus a target range of 3.5-4.0x, and the company has flagged a dividend payout range of 70-90% of profits excluding significant items. Even at the very top of the dividend payout range, we estimate that gearing will reduce at a pace of ~0.3x pa, creating headroom for ~\$700m of on-market buybacks over the next two years.

Combined with our assumption of revenue growth of 4% pa through the cycle and some continued margin benefit from the switch to digital, we see The Lottery Corporation delivering double-digit earnings growth over FY23-25. When compared to other defensives listed on the ASX, the valuation is very attractive considering its forecasted earnings growth.

**Figure 6: ASX-listed defensive companies - PE ratio vs earnings growth**



Source: Firetrail, Factset

In the short-term, The Lottery Corporation’s earnings could be negatively impacted by what has been an unfavourable jackpot run in the past few months. However, this has no impact on the attractiveness of the company’s long-term “infrastructure-like” cash flows. On the contrary, current cyclical softness creates an opportunity for us to increase exposure to businesses like The Lottery Corporation at more attractive valuations in order to maximise returns for our investors.

There have been a number of M&A transactions in recent years that have reinforced the attractiveness of businesses with “infrastructure-like” earnings. Sydney Airport is now in private hands, and stakes in the mobile tower assets of two Australian telecommunications operators have been sold at very healthy multiples. Whether it is through public or private markets, we believe the significant value in The Lottery Corporation’s long-dated, defensive earnings and substantial cash generation will be realised within the next few years.

## ONE INTERESTING THING THAT HAPPENED THIS MONTH...

Two Firetrail portfolio managers were travelling through the northern hemisphere in September, visiting a number of portfolio companies, their competitors and other industry contacts. One key takeaway from our time in the US was the substantial market share opportunity on offer for James Hardie Industries, a key holding in the Firetrail High Conviction Fund.

Building codes in Texas, Arkansas and Oklahoma are moving away from mandated masonry requirements and towards mixed materials like fibre cement. James Hardie has historically had limited success in the large Southwestern US market. However, given its expertise in mixed materials, James Hardie is now in a strong position to capitalise on a more favourable environment for the sale of its products.

**Figure 7: A typical Texan full brick home**



Source: Firetrail

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Link to the Product Disclosure Statement: [WHT3810AU](#)

Link to the Target Market Determination: [WHT3810AU](#)

For historic TMD's please contact Pinnacle client service Phone 1300 010 311 or Email [service@pinnacleinvestment.com](mailto:service@pinnacleinvestment.com)

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