

FIRETRAIL AUSTRALIAN HIGH CONVICTION FUND

MONTHLY REPORT | DECEMBER 2022

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.	10 Years p.a.	Strategy inception p.a. ⁵
Fund ²	(1.95%)	9.13%	(5.24%)	5.17%	5.03%	-	-	-	-
Strategy composite ⁴	(1.95%)	9.13%	(5.24%)	5.17%	-	6.13%	9.93%	11.48%	9.10%
Benchmark	(3.21%)	9.40%	(1.08%)	5.55%	7.63%	8.58%	9.32%	9.33%	7.00%
Excess Return	+1.26%	-0.27%	-4.17%	-0.38%	-2.60%	-2.45%	+0.61%	+2.15%	+2.10%

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 – 31 DEC 2022

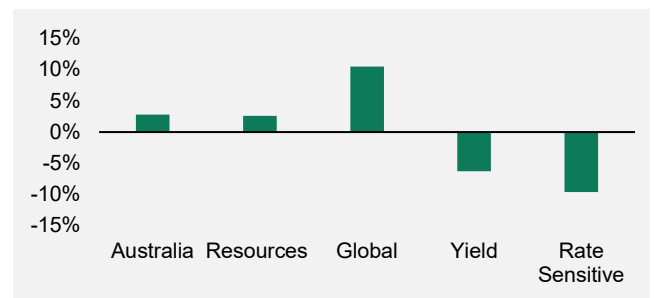
Top 3 Overweight Holdings (Alphabetical)
Newcrest Mining Ltd
Santos Ltd
Virgin Money UK PLC

FUND DETAILS

Unit Prices	31 December 2022
Application price	\$1.1432
Redemption Price	\$1.1398
NAV Price	\$1.1415
Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Risk/Return Profile	High
Number of Holdings	23
Fund size	\$667mil
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 – 31 DEC 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. 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 1.95% (after fees) for the month ending 31 December 2022, outperforming the ASX 200 Accumulation Index by 1.26%.

For the quarter ending 31 December 2022, the Fund returned 9.13%, underperforming the ASX 200 Accumulation Index by 0.27%.

CONTRIBUTORS TO RETURNS

Positive contributors included Virgin Money UK, Newcrest Mining and QBE Insurance. Negative contributors included ResMed, Lynas Rare Earths and our underweight holding in iron ore names. We discuss each further in our commentary below.

POSITIVE CONTRIBUTORS

Virgin Money UK

Virgin Money UK shares outperformed the ASX 200 and UK bank peers following a strong FY22 result. The macro environment remains supportive of net interest margins, with hawkish central bank commentary driving a 50 basis point rise in UK 10-year bond yields during December. Virgin Money UK has now outperformed the ASX 200 by 50% from its October lows.

Newcrest Mining

Newcrest Mining shares outperformed as the USD gold price rose 4%. During the month, Newcrest also announced the retirement of its long-serving CEO, Sandeep Biswas. Current CFO, Sherry Duhe, has assumed the role of interim CEO while the search for a replacement is completed.

QBE Insurance

QBE Insurance shares outperformed as global bond yields rose and the market became more comfortable with FY22 earnings expectations. While QBE downgraded earnings guidance in late November, the scale of the downgrade was relatively modest in the context of a volatile CY22.

NEGATIVE CONTRIBUTORS

ResMed

ResMed shares underperformed as the healthcare sector trailed the ASX 200 modestly. During the month, ResMed's main competitor, Philips, provided positive results from the testing it has carried out on recalled CPAP devices. However, Philips is yet to receive feedback from the FDA on the data.

Lynas Rare Earths

Lynas Rare Earths shares underperformed despite the price of its most valuable rare earth, NdPr, rising by 8% over December. The underperformance appeared to be associated with the selloff in lithium names, driven by a decline in the price of spodumene (a key mineral containing lithium).

Underweight iron ore names (BHP, Rio Tinto, Fortescue)

The Australian High Conviction Fund holds a below-index position in BHP and has no holdings in Rio Tinto and Fortescue. Increased confidence around China reopening supported the iron ore names, contributing negatively to Fund performance.

PORTFOLIO POSITIONING

Our positioning across each of our thematic categories can be summarised as follows:

- **Australia** – Overweight cyclicals with strong market positions like Qantas Airways and SEEK, and defensives like Ramsay Health Care and The Lottery Corporation. Underweight consumer staples and consumer discretionary.
- **Resources** – Overweight energy and decarbonisation metals through Santos, Alumina and Lynas Rare Earths. Underweight iron ore.
- **Global** – Overweight robust defensives in healthcare like ResMed and CSL.
- **Yield** – Overweight gold via Newcrest Mining. Underweight real estate and infrastructure stocks.
- **Rate Sensitive** – Overweight QBE Insurance and Virgin Money UK. Underweight Australian banks.

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

2022: YEAR IN REVIEW

We entered 2022 positioned for an environment of rising interest rates and resilient global demand. While this outlook played out directionally, the pace and quantum of interest rate rises was ahead of what we anticipated.

As we discuss further below, the rapid change in interest rates led to the underperformance of some of our positions in long-duration growth and cyclical stocks, which more than offset positive contributions from energy and financial exposures.

The Fund returned negative 5.24% for the year, underperforming the ASX 200 Accumulation index by 4.17%. While we were disappointed with the underperformance, we believe that adherence to our philosophy and process over this tumultuous period has allowed us to set the portfolio up for substantial outperformance over coming years.

CONTRIBUTORS

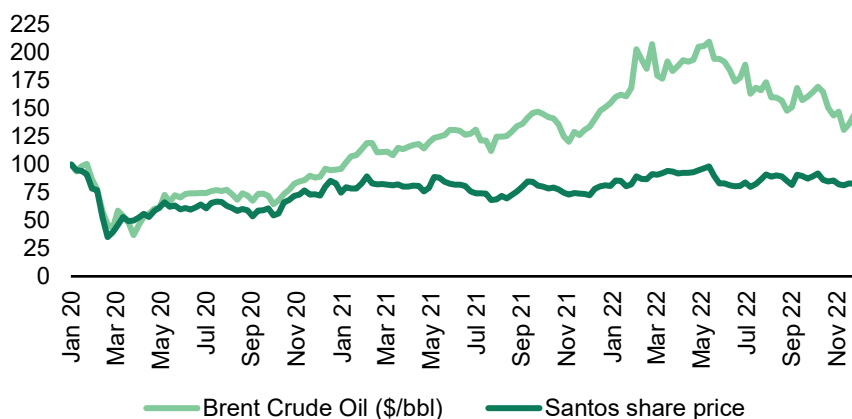
Santos

The top contributor for the year was our position in Santos. The Brent Crude Oil price finished the year at US\$86/bbl, US\$6/bbl higher than it started the year. There were four key forces on the market:

1. Supply disruption from the Russia-Ukraine conflict which didn't eventuate in oil, but did in gas.
2. Demand pressure from slowing economies.
3. COVID lockdown in China.
4. OPEC+ lifting production followed by cutting production late in the year.

Despite outperforming the ASX 200 by ~20% in 2022, the Santos share price remains below pre-COVID levels on both an absolute and relative basis, even though the oil price is 50% higher. We retain a large holding in Santos due to our continued positive outlook for energy. We believe the market is materially undervaluing Santos' portfolio of producing and growth assets.

Figure 1: Despite outperforming the ASX 200, the Santos share price still lags the elevated oil price (indexed to 100 at 31 Jan 2020)



Source: Factset, Firetrail

QBE Insurance

QBE Insurance outperformed the ASX 200 by 25% over the calendar year. The significant rise in global bond yields was a key driver, with the running yield on QBE's USD \$24 billion of fixed income investments rising by 3%. At the same time, the insurance industry continued to lift prices at a solid pace. For the year to September, QBE increased prices by an average of 8% across its global business and grew total premiums by 16% as a result.

The new CEO, Andrew Horton, has used favourable insurance conditions to begin reducing QBE's concentration to areas like US hurricanes, with the aim of turning QBE into a business with more predictable earnings. We believe that more predictable earnings will lead to a higher multiple applied to QBE's earnings, leading to significant shareholder returns.

Origin Energy

We initiated a position in Origin Energy in May 2022, believing there was substantial value in its suite of assets that are well positioned for the energy transition. Our view on Origin was confirmed six months later when a takeover bid was launched by Brookfield and EIG Group at a 55% premium to the last closing price. At the time of writing, the Origin share price is trading at a 20% discount to the \$9 bid price and we continue to hold the company.

Other strong contributors to portfolio returns during 2022 included Virgin Money UK and Qantas Airways.

DETRACTORS

Our negative contributors for the year largely fell into one of two buckets:

1. Long-duration growth stocks like Megaport and SEEK that sold off as interest rates rose; and
2. Property-exposed stocks like James Hardie and Lendlease which underperformed as the near-term outlook for property deteriorated.

In some instances, we used the selloff as an opportunity to increase our position size. For example, we have recently added to our SEEK position. We believe SEEK's earnings will prove to be less cyclical through a downturn than the market expects.

On the other hand, companies like James Hardie and Lendlease face a difficult near-term earnings outlook given the pace at which the macro environment shifted against them in 2022. We have not increased position sizes in these stocks. However, we continue to hold both companies as we believe their share prices are now pricing in much deeper negative conditions than we think is realistic.

A significant benefit of the current dynamic environment is the level of mispricing that can occur. COVID presented us with several attractive investment opportunities, and we believe 2022 has done the same. Portfolio turnover of 60% in 2022 was above 2021, and not far below the elevated turnover we saw in 2020. Our style-neutral, fundamental approach identified new investment opportunities across different market segments including Ramsay Health Care (defensive), Domino's Pizza (growth), Incitec Pivot (cyclical) and Alumina (resources).

With more volatility in share prices, we are also using opportunities to buy and sell around existing positions more than usual. For example, we were very active in trading ResMed throughout the year as the market over and under-reacted to earnings announcements and news on availability of devices. Despite our valuation remaining broadly unchanged throughout the year, ResMed traded as low as \$27 and as high as \$35 per share.

Some of the larger positions we exited during the year were Amcor, Aristocrat and Telstra. All three stocks delivered positive performance over the period of our investment, but had reached valuation levels that did not adequately capture some earnings risks that we see emerging.

2023: OUTLOOK AND POSITIONING

As we enter 2023, businesses continue to grapple with inflationary cost pressures, but now have the accompanying issue of a slowing demand environment. As the lagged impact of central bank rate tightening filters through the economy and conditions get tougher, only the best businesses will navigate effectively. Weak businesses will be under pressure.

For 2023, consensus is expecting 10% growth in earnings per share (EPS) for the ASX 200 ex-Resources. In talking to companies and doing our own analysis, we believe that will prove too optimistic. Our style-neutral, fundamental approach allows us to look through the short-term noise to find significant medium-term upside. We have identified opportunities in sectors like healthcare and energy, but believe the banks have now baked in all the good news.

Healthcare (overweight)

The Fund is substantially overweight the healthcare sector through our holdings in ResMed, CSL and Ramsay Health Care. The defensive nature of healthcare is an attractive feature supporting all three companies, however our high conviction in these names is derived from our bottom up work.

ResMed

We are now 18 months on from when ResMed’s main competitor, Philips, first announced its CPAP product recall due to safety issues. Despite Philips being temporarily out of action, ResMed has been hamstrung due to a global semiconductor shortage. The chip shortage has prevented ResMed from being able to supply the soaring demand of customers. As chip shortages ease, which is happening right now, we believe 2023 calendar year earnings will beat expectations.

While Philips is nearing the end of its repair/replacement program, it continues to negotiate with the FDA on a consent decree. Historically, consent decrees have materially impacted a manufacturer’s ability to operate freely. We expect Philips to remain heavily constrained for at least another 12 months, which will benefit ResMed for many years via a higher installed base and a focussed team in product and sales.

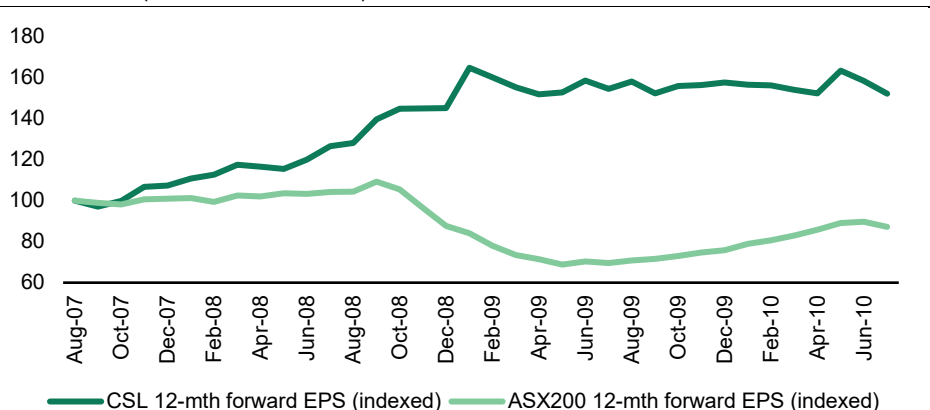
CSL

CSL’s main plasma division will benefit from the recovery in plasma collections, which only returned to pre-COVID levels in mid-2022. Plasma collections flow through to earnings with a lag, which suggests 2023/24 will be strong years for earnings.

In our view, CSL is the ultimate defensive. The cost of collecting plasma tends to run counter to the economic cycle. Tougher economic conditions lead to an increase in donors, typically at lower cost.

While there were industry-specific factors at play, the value of holding a stock like CSL through an economic downturn is displayed below. CSL grew earnings per share (EPS) by 60% during the GFC, compared to a 20% fall in EPS for the ASX 200.

Figure 2: CSL grew EPS by 60% during the GFC, compared to a 20% fall in EPS for the ASX 200. (EPS indexed to 100)



Source: Factset, Firetrail

Ramsay Health Care

Ramsay is one of the COVID reopeners that hasn’t seen a return to normal activity levels yet. However, Ramsay will likely deliver above-trend growth in 2023/24 as the surgery backlog is addressed.

Nursing shortages and wage negotiations are placing pressure on Ramsay’s expenses line. However, the recent contract negotiation with BUPA illustrates that Ramsay is now flexing its muscles to offset these higher costs.

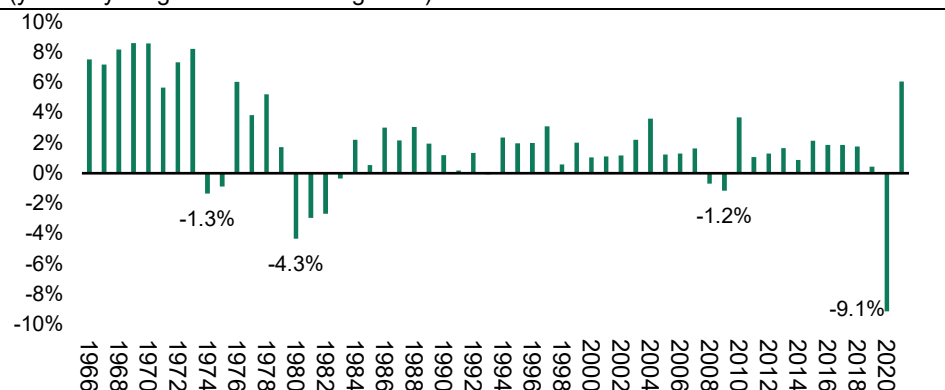
While ResMed, CSL and Ramsay all trade on FY23 PE ratios >30x, our process focusses on earnings and valuation three years into the future. We forecast FY25 EPS that is 35-40% higher than FY23 for all three stocks. On a three-year view, the healthcare stocks provide growth, relative earnings certainty, and valuation upside – an attractive triffecta in a tough environment.

Energy (overweight)

As a bellwether for the global economy, an investment in oil appears fraught while the world faces elevated risk of recession. However, observed experience through other recessions over the past fifty years illustrates that significant declines in oil demand are rare. The only times we have seen single-year reductions of more than 1.5% were after the 1979 Iranian revolution (where 7% of the world’s supply was lost) and during COVID in 2020.

We are expecting a modest decline in 'underlying' oil demand on a weak economy. But once you add an expected tailwind from China reopening in 2023, and the return of global aviation, we believe short-medium term oil demand will remain resilient.

Figure 3: Over the last 50 years, significant declines in oil demand have been rare (year on year global oil demand growth)



Source: BP, Firetrail

On the supply side, energy is facing a supply crunch. Despite rising prices, investing in new projects is getting harder. Hurdles to investment include lack of funding, regulation and environment barriers, and shareholder pressure for capital discipline. OPEC, which controls 30% of global supply, also remains rational. OPEC cut production in November and commented that “if there is a need to take further measures by reducing production to balance supply and demand, we always remain ready to intervene”.

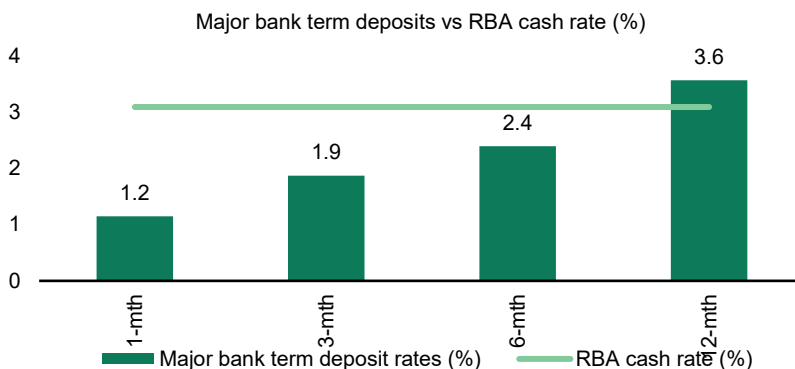
One of the key watch points for supply in 2023 is Russia. Russia supplies 10% of global oil. So far, there have been no oil outages, but Russia has shown a willingness to use energy supply to influence outcomes. In the case of Europe, Russia cut off more than 80% of pipeline gas supply during 2022.

Our preferred exposure in the energy space remains Santos. At a US\$70/bbl oil price, we estimate Santos can return \$800 million to shareholders (5% annual yield via mix of dividends and buybacks) and complete sanctioned growth projects that will lead to production 30% higher over the next five years.

Major banks (underweight)

To date, banks have benefited from the RBA's aggressive rate hikes. Of the 300 basis points of RBA base rate increases, almost all has been passed on to mortgagors and business borrowers, but only a modest proportion has gone to depositors. While 12-month term deposit rates are ~0.5% above the cash rate, short-term deposits are still well below. The 1-month term deposit rate is almost 2% below cash!

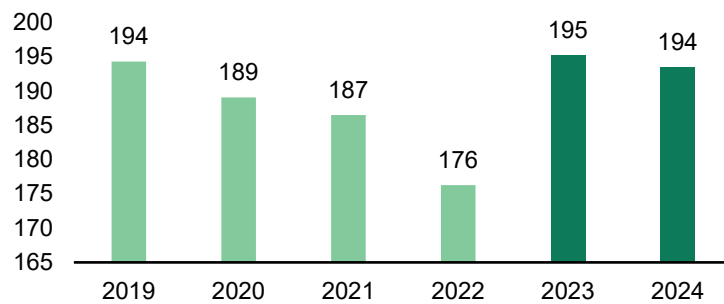
Figure 4: Major Australian banks have not passed on RBA cash rate rises to depositors



Source: Credit Suisse, Firetrail

As a result, major bank net interest margins (NIMs) are forecast to expand by almost 20 basis points or 10% in FY23, driving material revenue growth.

Figure 5: Australian major bank consensus NIM forecasts for FY23 and FY24 (basis points)



Source: Visible Alpha, Firetrail

While further RBA rate hikes are expected in 2023, we believe deposit competition and offered rates will pick up as excess liquidity in the system dries up. The re-emergence of competition poses risks to FY24 NIM forecasts in our view.

Against this revenue profile, consensus is forecasting aggregate expense growth of 2% in FY23 and 1% in FY24. Banks are removing costs to offset inflation. However, with staff costs rising by mid-single digit rates, such low consensus cost growth estimates look VERY optimistic.

The Australian bank sector screens cheap versus its history on FY23 earnings. However, we believe FY23 will be a year with peak margins, understated costs, and very low bad debts. It doesn't get any better and earnings almost certainly go backwards in FY24/25. We prefer to gain exposure to higher interest rates through Virgin Money UK and QBE Insurance.

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

Two separate announcements with one common theme caught our eye in December:

1. The Federal Government cap on East Coast gas prices at A\$12 per gigajoule.
2. The NSW Government proposed increase to taxes on slot machines in Sydney casinos.

In the current environment, any industry making a high level of profit is at risk of Government intervention. Government fiscal buffers were depleted during COVID and we expect they will aim to rebuild. We expect more taxes and more intervention both in Australia and across the world.

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

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

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