

FIRETRAIL AUSTRALIAN HIGH CONVICTION FUND

MONTHLY REPORT | MARCH 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. | 7 Years p.a. | 10 Years p.a. | Strategy inception p.a. ⁴ |
|---------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------------------------|---------------|---------------|---------------|--------------------------------------|
| Fund ¹ | 4.11% | 1.30% | 3.89% | 12.61% | 31.92% | 10.89% | 7.76% | - | - | - | - |
| Strategy composite ³ | 4.11% | 1.30% | 3.89% | 12.61% | 31.92% | 10.89% | - | 9.95% | 12.17% | 12.94% | 10.00% |
| Benchmark | 6.89% | 2.24% | 4.38% | 14.97% | 25.72% | 10.59% | 10.01% | 10.13% | 9.25% | 10.99% | 7.56% |
| Excess Return | -2.77% | -0.95% | -0.49% | -2.36% | +6.20% | +0.30% | -2.25% | -0.18% | +2.92% | +1.96% | +2.44% |

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.

PORTFOLIO POSITIONING 31 MARCH 2022

Top 3 Overweight Holdings (Alphabetical)

| |
|-------------------------|
| QBE Insurance Group Ltd |
| ResMed Inc |
| Santos Ltd |

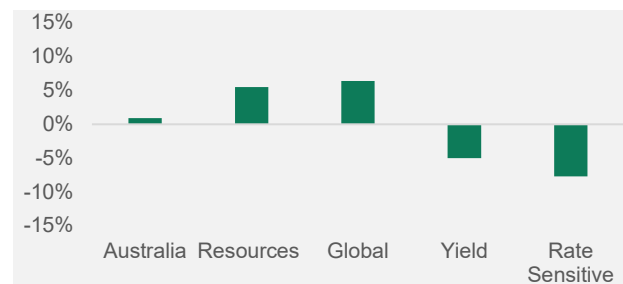
FUND DETAILS

| Unit Prices | 31 March 2022 |
|--------------------|--|
| Application price | \$ 1.2849 |
| Redemption Price | \$ 1.2811 |
| NAV Price | \$ 1.2830 |
| Fund Details | |
| APIR Code | WHT3810AU |
| Benchmark | S&P/ASX 200 Accumulation Index |
| Inception date | 14 March 2018 |
| Number of Holdings | 25 |
| Fund size | \$686mil |
| 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 MARCH 2022

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.

1. 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. 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 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. 4. Strategy inception 29 November 2005.

PORTFOLIO COMMENTARY

For the month of March, the High Conviction Fund returned 4.11%, underperforming the ASX 200 Accumulation Index by 2.77%.

The Fund returned 1.30% for the quarter ending 31 March 2022, underperforming the ASX 200 Accumulation Index by 0.95%.

CONTRIBUTORS TO RETURNS

Positive contributors included Seek, Nufarm and Woodside Petroleum. Negative contributors included Virgin Money UK, ResMed and a nil holding in Commonwealth Bank. We discuss each further in our commentary below.

POSITIVE CONTRIBUTORS

Seek

Tech stocks partially recovered in March, after selling off through January and February on higher interest rate expectations. Seek didn't report any new company-specific information, however its result in February confirmed that the business is in a strong position to benefit from tight labour market conditions in Australia.

Nufarm

The Russia/Ukraine conflict has lifted soft commodity prices further and raised concerns about global food supply. These conditions should drive increased plantings, which will support demand for Nufarm's crop protection products.

Woodside Petroleum

Woodside outperformed due to its leverage to spot LNG prices. LNG prices rose 26% over the month, at one point being 86% above February-end levels.

NEGATIVE CONTRIBUTORS

Virgin Money UK

Virgin Money UK underperformed in March alongside the other UK banks, with the market becoming more concerned about stagflation in the UK. The weakness of the Pound versus the Australian Dollar also had a negative impact.

ResMed

In a conference presentation, ResMed's CEO Mick Farrell highlighted continued difficulties in securing adequate chip supply to satisfy demand. While guidance for a \$300-350 million benefit from the Philips recall was not changed, the CEO flagged that this is now looking more challenging to achieve. During March, the FDA issued another order to Philips regarding poor communication to its customers, suggesting the recall continues to encounter challenges.

Commonwealth Bank (nil holdings)

Following its 1H22 result in February, Commonwealth Bank didn't report any material news in March. We believe CBA's share price benefitted from a flight to quality large-cap Financials during March.

PORTFOLIO POSITIONING AND CHANGES

Material changes made to the portfolio over the March quarter include:

- Initiated a position in ANZ Banking Group due to our view that net interest margins and balance sheet growth will improve over 2H22/FY23.
- Increased our positions in BlueScope Steel, QBE Insurance Group, James Hardie Industries and ResMed as the market continues to under-estimate the medium-term earnings trajectory.
- Reduced our positions in OZ Minerals, Lynas Rare Earths and Newcrest Mining.
- Exited our position in Crown Resorts as it was trading at a reasonably tight discount to takeover terms, and we saw better opportunities elsewhere.

Current portfolio positioning can be summarised as follows:

- Highly concentrated with an active share of 75%.
- Overweight
 - Re-opening trades like Qantas Airways and the Energy sector, where competitive dynamics have improved post COVID.
 - Base metal and EV materials where supply won't be able to keep up with demand in the medium-term.
 - Housing plays like BlueScope Steel and James Hardie Industries who are benefitting from strong demand while taking market share in their categories.
 - Non-bank Financials including QBE Insurance Group which should materially benefit from higher interest rates.
 - Undervalued defensive companies including Newcrest Mining, Telstra and Tabcorp.
- Underweight positions in Australian banks and iron ore.

JAMES HARDIE INDUSTRIES DEEP DIVE

We recently added to our position in James Hardie, a global manufacturer of fibre cement siding products for houses. Fibre cement is a material made from sand, cement, and cellulose. It is more durable than wood, looks and wears better than vinyl, and is more time and cost-effective than brick.

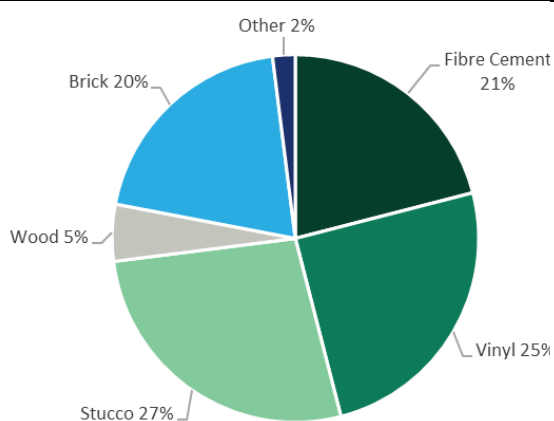
Recent noise around interest rates and the US housing market has not diminished our view that a material market share and margin-accretion opportunity lay ahead of James Hardie over the next 3-5 years.



Source: James Hardie

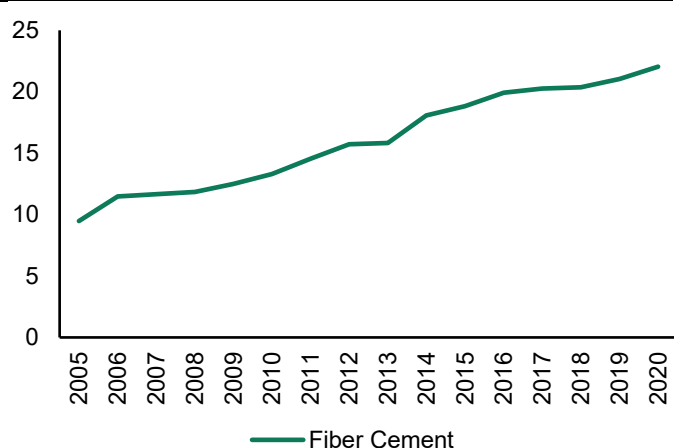
The majority of the company's products are sold in the US, where fibre cement sales have grown from less than 10% of the exterior siding market in 2005 to 21% today.

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 (%)



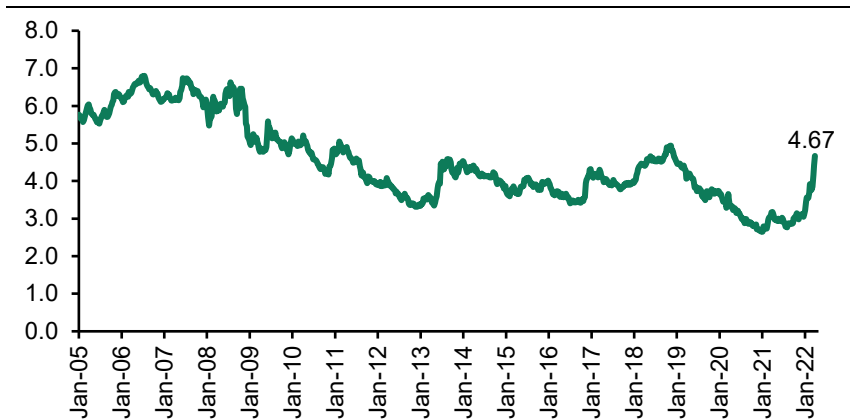
Source: Census Bureau, Firetrail

James Hardie's #1 position in this segment has led to an impressive compound annual growth rate (CAGR) in North America revenue of 12% over the past decade.

Interest rates are going up – what does this mean for growth?

The key question for James Hardie is how the US housing market will perform in an environment of higher interest rates. The US mortgage market is largely a long-term fixed rate market, and 30-year fixed rates are close to the highest they've been in over a decade at just under 5% p.a.

Figure 3: US 30-year fixed mortgage rates (%)



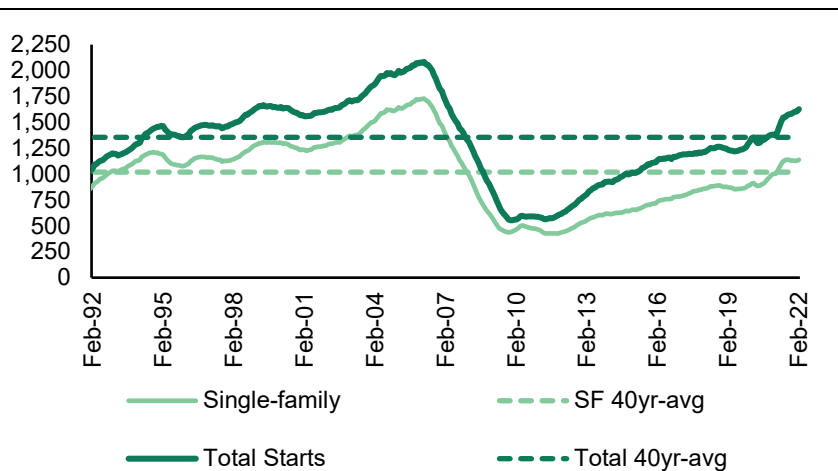
Source: Census Bureau, Firetrail

Roughly 30% of demand for James Hardie’s siding products comes from the construction of new homes, with the remaining 70% from the repair and renovation (R&R) market. While both segments are impacted by interest rates, the new home market tends to be far more cyclical than the R&R market. James Hardie’s skew to R&R provides some degree of defensiveness compared with builders primarily exposed to new homes.

Also, there are five key reasons we think the US housing market is entering this period of higher interest rates in a much stronger position than before the Global Financial Crisis.

- Housing starts (new residential construction projects) have only just recovered to mid-cycle levels. Pre-GFC, single-family housing starts were 750k above mid-cycle.**

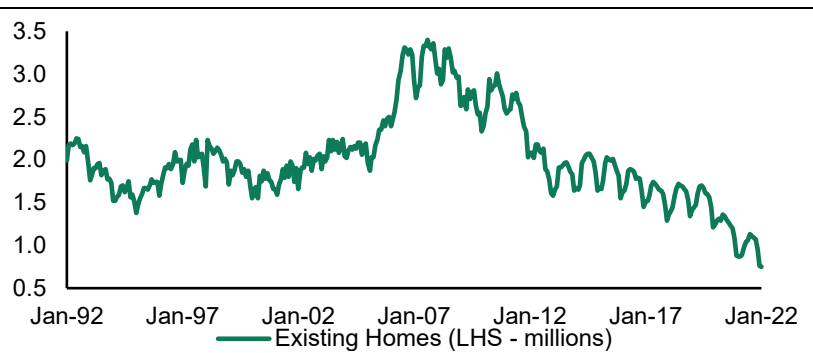
Figure 4: US Housing starts (thousand units)



Source: Census Bureau, Firetrail

2. 'Homes available for sale' (inventory) is the lowest it has been for over 30 years.

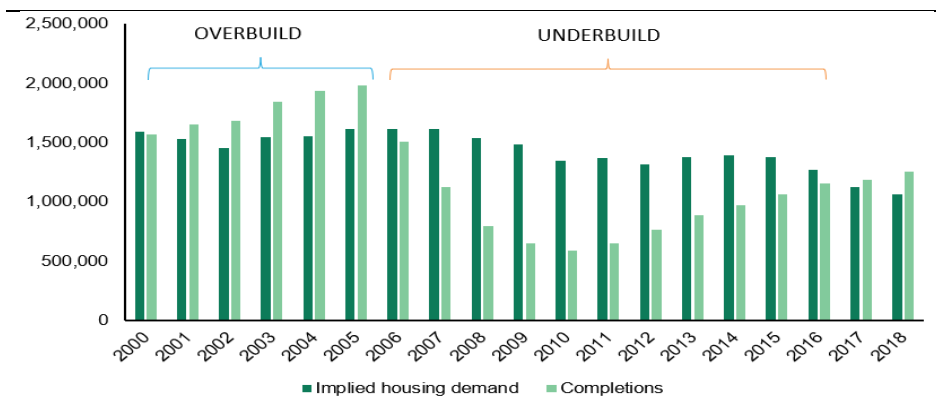
Figure 5: Single family housing inventory (millions)



Source: Census Bureau, Firetrail

3. The pre-GFC overbuild has become a significant underbuild vs demand over the last 15 years.

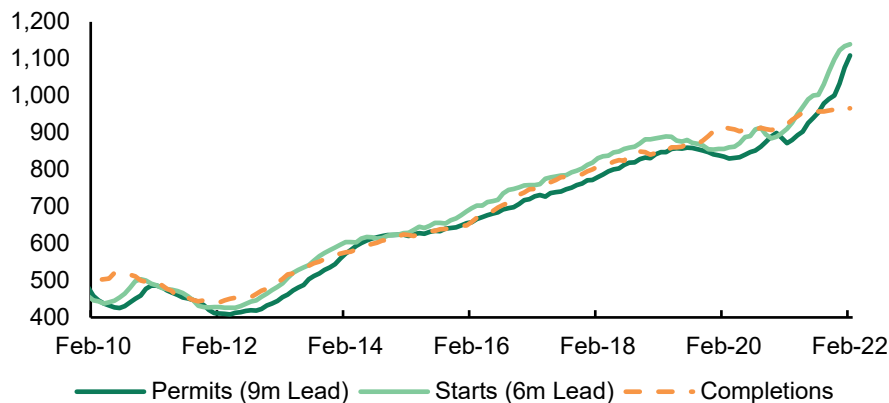
Figure 6: US implied housing demand vs completions since 2000



Source: Census Bureau, Firetrail

4. Due to supply chain bottlenecks, US homebuilders are facing significant backlogs with no excess capacity in the market. Housing completions are meaningfully lagging housing starts.

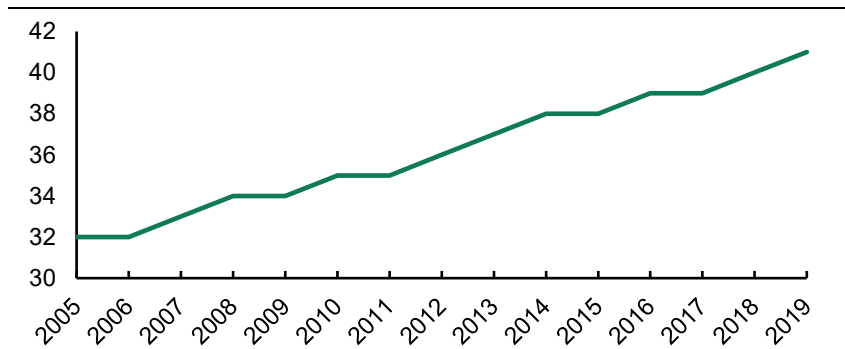
Figure 7: US capacity shortages means the backlog will only get wider. US housing permits, starts and completions below (thousands)



Source: Census Bureau, Firetrail

5. The median age of US housing stock is ~41 years, 10 years higher than it was in 2005.

Figure 8: Median age of housing stock (years)



Source: Census Bureau, Firetrail

The long-term prize

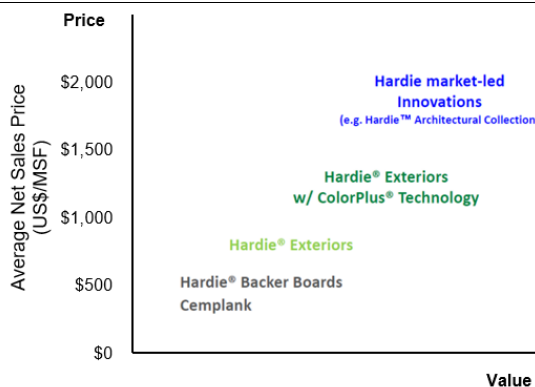
Alongside its core fibre cement products, James Hardie has an established track record of innovating and selling higher value products. The company’s most recent success has been “ColorPlus”, a fibre cement product that is painted as part of the manufacturing process. The next leg to this strategy is the “Architectural Collection”, a set of premium products with varying textures and finishes. An example is shown below:



Source: James Hardie

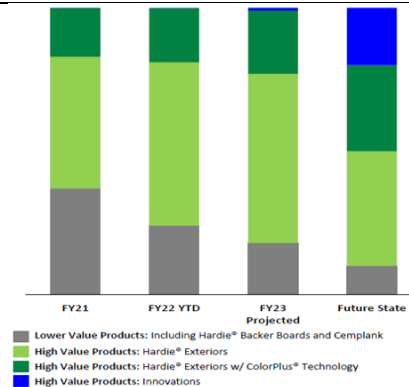
James Hardie’s “ColorPlus” and “Architectural Collection” products are priced at a 50-150% premium to traditional Hardie Exterior products. While this looks high at face value, the difference in total cost to the consumer is not as large due to savings associated with painting and installation.

Figure 9: James Hardie - North America price/value matrix



Source: James Hardie

Figure 10: James Hardie North America volume mix

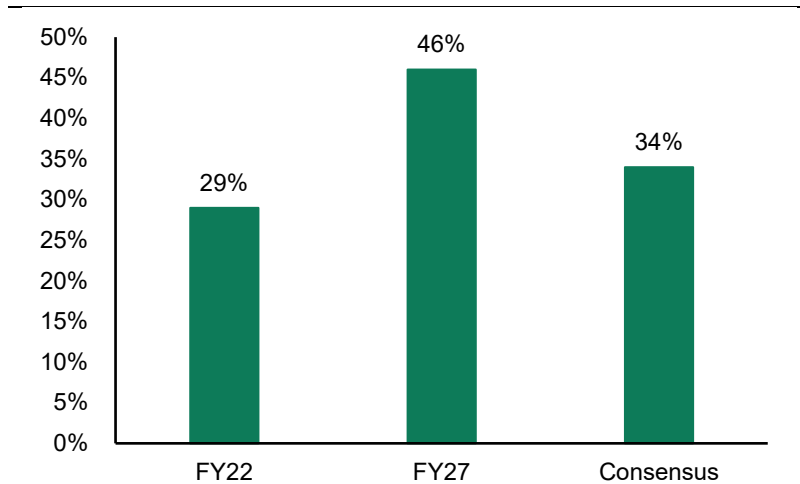


Source: James Hardie

The cost of manufacture for James Hardie is not too different across each product type. As the product mix moves towards the targeted “Future State” shown above, the implied margin accretion is material.

We estimate that current North America margins of 29% could increase to 46% if the target product mix is achieved, and if 30% of the profit uplift is reinvested. This is materially higher than consensus FY27 margins of 34%.

Figure 11: EBIT margin assuming 30% of uplift is reinvested

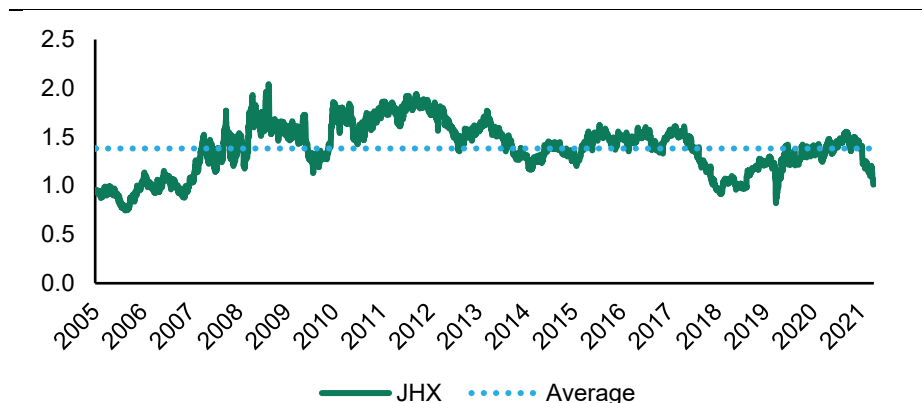


Source: Firetrail

Share price already factoring in a demand hit

Over the past six months, James Hardie has de-rated from a 50% premium to the ASX 200 to now being priced at a market multiple of consensus earnings. Note the CEO departed during this period for conduct reasons, but James Hardie also upgraded its FY22 and FY23 earnings guidance.

Figure 12: James Hardie PE relative to ASX 200



Source: Firetrail

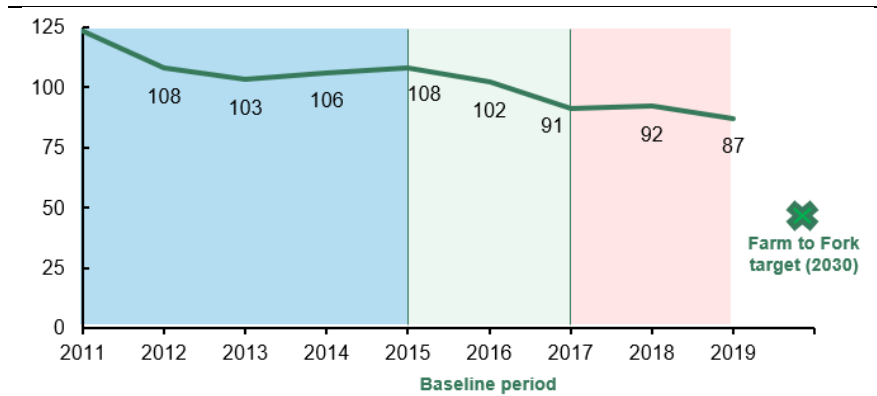
The stock did trade as low as a 20% discount to the market pre-GFC, so we cannot discount the risk of some short-term share price dislocation. However, with the housing market seemingly on firmer footing than in 2006/07 and a material market share opportunity on offer for James Hardie, we believe the share price represents compelling value at current levels.

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

In May 2020, the European Commission announced its “Farm to Fork” strategy, which called for a 50% reduction in chemical and hazardous pesticide use by 2030. These targets remain the most aggressive globally and pose challenges for businesses like Nufarm, who will need to find replacement markets and bio alternatives over coming years.

However, in March 2022, French President Emmanuel Macron suggested that the Farm to Fork targets are no longer appropriate post the Russia/Ukraine conflict and may need to be reviewed. Macron’s comments are indicative of how food security is moving front of mind for several large economies and will likely result in changes to long-term priorities.

Figure 13: EU trend in the use and risk of chemical pesticides (based to 100 as the average over 2015-2017 baseline period)



Source: European Commission, 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

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