

FIRETRAIL AUSTRALIAN HIGH CONVICTION 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.	7 Years p.a.	10 Years p.a.	Strategy inception p.a. ⁴
Fund ¹	(8.39%)	(12.83%)	(11.70%)	(6.53%)	11.97%	4.52%	3.92%	-	-	-	-
Strategy composite ³	(8.39%)	(12.83%)	(11.70%)	(6.53%)	11.97%	4.52%	-	5.74%	7.95%	10.19%	8.92%
Benchmark	(8.77%)	(11.90%)	(9.93%)	(6.47%)	9.33%	3.34%	6.22%	6.37%	5.79%	8.71%	6.61%
Excess Return	+0.38%	-0.93%	-1.78%	-0.06%	+2.64%	+1.19%	-2.31%	-0.63%	+2.16%	+1.48%	+2.31%

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 30 JUNE 2022

Top 3 Overweight Holdings (Alphabetical)

QBE Insurance Group Ltd
ResMed Inc
Santos Ltd

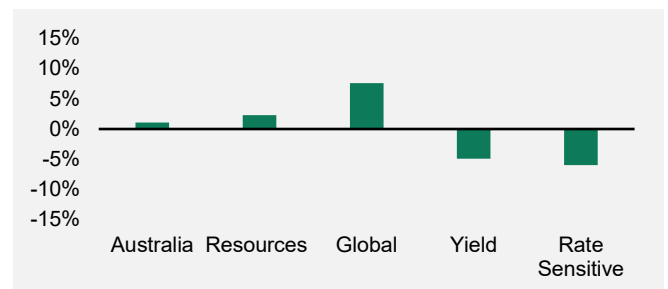
FUND DETAILS

Unit Prices ¹	30 June 2022
Application price	\$ 1.1201
Redemption Price	\$ 1.1167
NAV Price	\$ 1.1184
Fund Details	
APIR Code	WHT3810AU
Benchmark	S&P/ASX 200 Accumulation Index
Inception date	14 March 2018
Number of Holdings	26
Fund size	\$624mil
Management fee*	0.90% p.a.
Performance fee*	15% 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

THEMATIC POSITIONING - 30 JUNE 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

The Fund returned negative 8.39% for the month ending 30 June 2022, outperforming the ASX 200 Accumulation Index by 0.38%.

For the quarter ending 30 June 2022, the Fund returned negative 12.83%, underperforming the ASX 200 Accumulation Index by 0.93%.

CONTRIBUTORS TO RETURNS

Positive contributors included ResMed, QBE Insurance and Ampol. Negative contributors included OZ Minerals, Qantas Airways and Newcrest Mining. We discuss each further in our commentary below.

POSITIVE CONTRIBUTORS

ResMed

ResMed announced the acquisition of MediFox Dan, a software solutions provider for home health therapists and nursing homes in Germany. The business is modest in size compared to ResMed but strategically important as it establishes a European beachhead for ResMed's SaaS division. We attribute share price outperformance during June to positive comments from the CEO around higher device sales as the company navigates supply chain issues.

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.

NEGATIVE CONTRIBUTORS

OZ Minerals

OZ Minerals provided an update to the market on 2022 production and cost expectations. Production guidance was lowered by 13% due to constraints on equipment availability and a temporary conveyor belt issue. Like other resource stocks in June, cost guidance was revised upwards. OZ Minerals flagged average inflation of ~8% across all of its assets, with higher costs being felt in labour, transport, fuel, explosives and ground support.

Qantas Airways

Qantas released an update that highlighted continued strong travel demand, a further \$500m reduction in net debt since April, and no change to 2H22 EBITDA guidance. In response to increased costs caused by higher oil prices, Qantas also stated that it will be reducing domestic capacity by 10-15% from July 2022 until March 2023. Provided Virgin takes similar steps, the profit pool for Qantas and the industry should remain relatively healthy despite lower numbers of flights overall.

Newcrest Mining

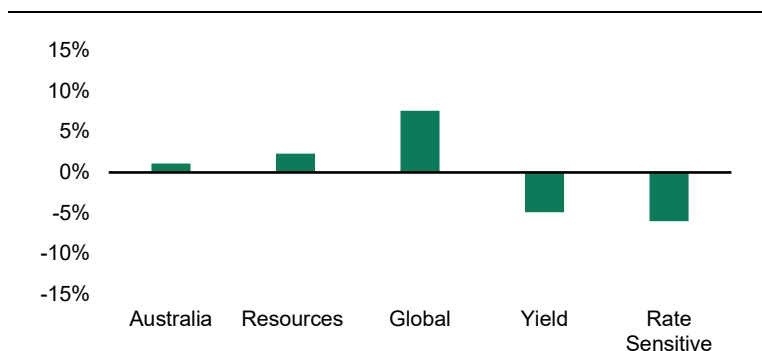
We didn't hear anything specific from Newcrest in June, but the stock underperformed as the gold price declined and peer gold miner Evolution Mining announced a significant cost increase. Evolution flagged 5-6% labour inflation, but it was the increased cost of diesel and substantial ramp up in East Coast power prices that were the major drivers. We understand Newcrest's East Coast power contract prices are fixed until sometime next year.

PORTFOLIO POSITIONING AND CHANGES

We begin FY23 with developed economies facing a period of monetary tightening, which is driving widespread stagflation fears. While the range of scenarios remains wide, it appears likely that consensus earnings estimates will be rebased lower over the year. However, share price valuations have already moved to factor in lower growth scenarios, with the one-year forward PE of the Australian market already down 5 PE points YTD.

With this backdrop, we believe it is appropriate to hold a relatively balanced portfolio in terms of thematic exposure, with stock-specific risk maintained at a high level. The chart below outlines our weightings across the five buckets that we use to measure thematic risk.

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



Source: Firetrail

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 Corp and Telstra. Underweight consumer staples.
- **Resources:** overweight oil 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 and Lendlease.
- **Yield:** underweight real estate and infrastructure stocks, overweight gold through our holding in Newcrest Mining.
- **Rate Sensitive:** underweight Aussie banks, overweight QBE Insurance and Virgin Money UK.

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

- Exited positions in Amcor, Woodside Energy and Xero
- Initiated positions in Origin Energy (funded by Woodside Energy) and CSL
- Increased position sizes in ResMed, Incitec Pivot and Tabcorp (ahead of the de-merger)
- Reduced position sizes in Qantas Airways, OZ Minerals and Seek

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

CSL DEEP DIVE

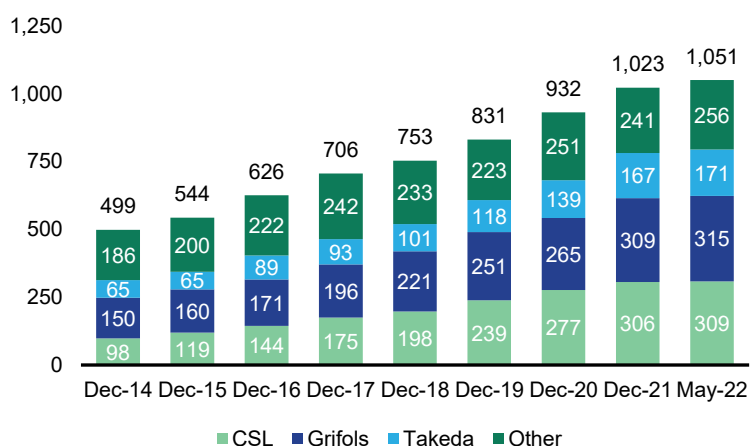
The High Conviction Fund built a position in CSL over the June quarter. The rapid pace at which the global economic backdrop is changing will likely mean that a number of headwinds CSL has faced in recent years will become tailwinds. Valuation is often the sticking point on CSL, but we believe the stock will outperform due to continued strong demand for its products, defensive cost position and +20%pa earnings growth over the next three years.

Plasma collections to drive improving margins

CSL’s core business involves collecting plasma and using it to manufacture products used in the treatment of immune and other rare diseases. It takes roughly 130 plasma donations from healthy donors to treat one primary immunodeficiency patient, so the volume and cost of collections is a key input for CSL’s plasma division, Behring.

The United States is one of the few countries globally that allows manufacturers to pay people for donations, and as a result is responsible for ~80% of the world’s plasma supply. Plasma is collected across more than 1,000 centres in the US, with an annual growth rate of ~10% pa supported by the demand for plasma-derived therapies. CSL operates 30% or just over 300 of these centres.

Figure 2: US plasma collection centres by operator



Source: CSL, Morgan Stanley Research

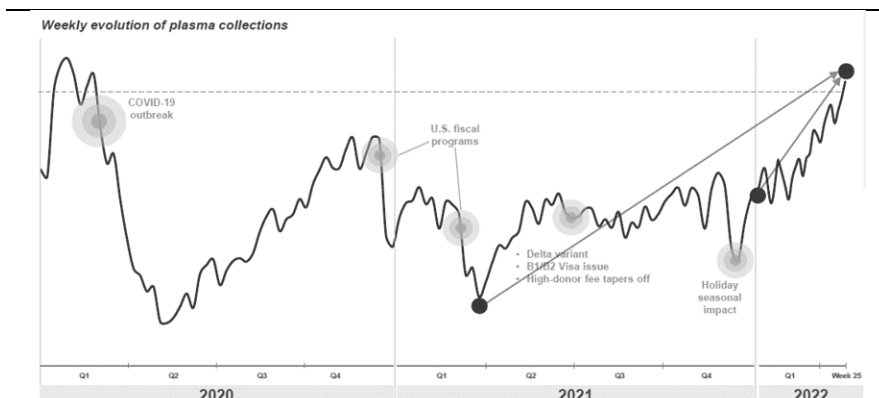
When the pandemic hit, collection volumes dropped sharply due to stay-at-home orders and large stimulus cheques that reduced donors’ need for supplemental income. Manufacturers like CSL had to start lifting donor fees materially to try to boost collections. At the same time the US Government banned people from Mexico travelling across the border to donate plasma. We believe the outlook across all of these drivers is now much more positive as shown in the table below:

Drivers of softer plasma collections	Outlook from here
COVID stay-at-home orders	Economy has reopened
Stimulus cheques	Rising unemployment
10% reduction in bed capacity	To be added back as donors return
Ban on Mexican donors	Looks likely to be reversed in CY22

Source: Firetrail

A recovering collection profile has been confirmed by a number of plasma companies including CSL in recent months. Most recently, the 2nd largest manufacturer Grifols provided a chart of its collection trajectory which illustrated it is now back above pre-COVID levels.

Figure 3: Plasma donations are back above pre-COVID levels

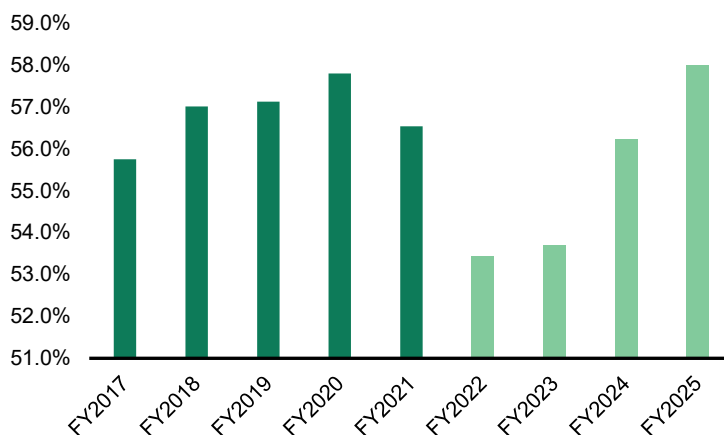


Source: Grifols

We expect that any weakening in US employment over coming periods will compound this positive trend. Our latest precedent was the GFC, during which we observed an increase in the volume of donors and a reduction in the average fee paid per donor.

Donor fees comprise 40-50% of the cost of collecting a litre of plasma. We expect lower fees and recovering volumes will drive an improvement in the gross margin of CSL’s Behring division from FY22 lows. It will however likely take until FY25 before pre-COVID margins are restored, due to the ~9-month time lag between when plasma is collected and finished products are sold.

Figure 4: Gross margins of CSL’s Behring division



Source: CSL, Firetrail estimates

Rika – a step change in plasma economics?

Rika is the name of the new plasma collection system that CSL is licensing from Terumo, a large Japanese medical equipment company. The device promises to increase collections at a lower cost. Progressively over FY23, CSL will replace the existing hardware in its collection centres with Rika devices. We believe the new devices will provide a competitive advantage over the rest of the market given a period of exclusivity that CSL has negotiated with Terumo.

Figure 5: Rika, CSL’s new plasma collection system.



Source: Terumo

The key benefits of Rika are expected to be:

- Shorter donation time (~35 mins vs ~50 mins currently).
- Increased donor comfort.
- Higher yield of plasma per donor.
- Cost savings on consumables.

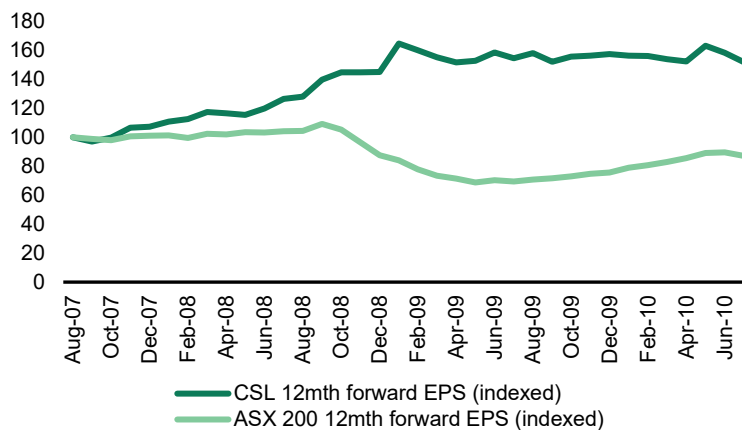
On our estimates, the Rika rollout could result in a ~15% reduction in cost/litre when Rika is fully ramped up, which would drive gross margins well above pre-COVID levels if achieved.

Valuation upside supported by earnings growth and certainty

On our forecasts, CSL’s core business will grow EPS at a 20% CAGR from FY22-25. An additional ~10% growth could be added if the announced acquisition of Vifor Pharma is completed.

While every cycle is different, it is worth reflecting on CSL’s earnings performance during the GFC compared to the broader market. CSL admittedly had some competitive factors working in its favour at the time, but nevertheless grew 12-month forward EPS by 60% over two years from Aug-07 to Aug-09, whereas EPS for the ASX200 fell by 25%.

Figure 6: CSL’s earnings were resilient during the GFC



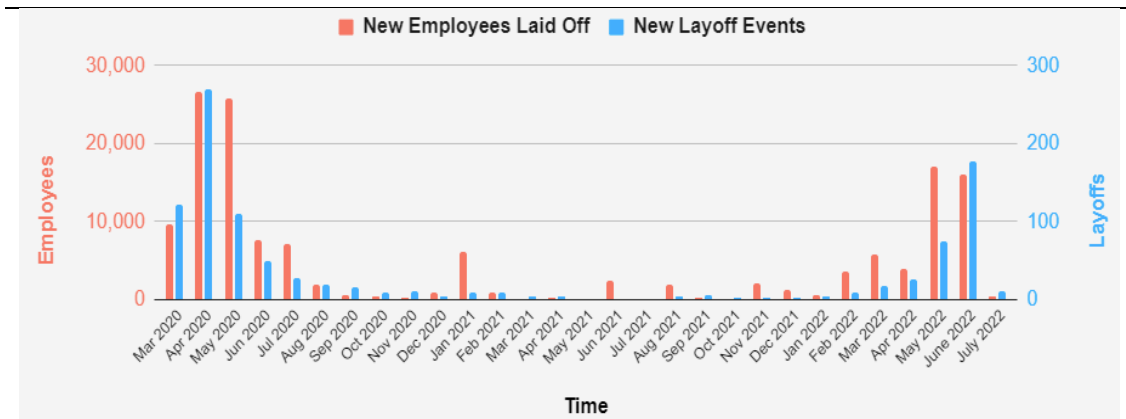
Source: Factset

ONE INTERESTING THING THAT HAPPENED THIS MONTH...

With unemployment rates still at multi-decade lows in Australia and many other developed economies, the market is looking for any data that can provide insight into future employment trends. One potential lead indicator is the data below on employee layoffs from US start-ups. More than 32,000 employees were laid off over May and June, which is already more than half the number that were laid off during the first few months of COVID.

Clearly a number of start-up business models are not geared to operate effectively in the current environment, but we also believe these conditions will expose a number of more traditional businesses that have benefitted from an extended period of near-zero interest rates.

Figure 7: US tech start-ups are laying off staff...



Source: layoffs.fyi

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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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