

# June 2022 Quarterly Report



# Aoris Investment Management

Aoris is a *specialist* international equity manager founded in 2017.

We are a *focused* business and manage a single international equity portfolio.

Our investment approach is *conservative*, fundamental and evidence-based.

## The Aoris International Fund

Our portfolio is long-only and highly *selective*.

We own a maximum of 15 stocks, each of which has considerable breadth or *internal diversification*.

We aim to generate returns of 8-12% p.a. over a market cycle.

## Our Quarterly Reports

We are *business owners*, not economists.  
As such, our reports focus on the performance of our investee companies.

We report on portfolio performance and changes with candour and transparency.

Each quarter, we include a thought piece or feature article on a topic area with direct relevance to our investment approach.

About the cover image: The Great Pyramids of Giza were built in the 26th century BCE as tombs from which Egyptian pharaohs would ascend to the afterlife. Accordingly, the pyramids were designed to last forever. They are the oldest of the Seven Wonders of the Ancient World, and the only ones to remain intact.

Great sphinx and pyramid, by givaga  
File ID: 1810839274; Shutterstock Images.

# Aoris International Fund

Performance to 30 June 2022	June Quarter	1 Year	Since Inception p.a.*
<b>Class A (Unhedged - base fee option)</b> Inception 26 March 2018			
<b>Portfolio return (AUD) - Net of all fees</b>	<b>-8.4%</b>	<b>-1.8%</b>	<b>11.6%</b>
MSCI AC World Accum Index ex-Australia (AUD)	-7.8%	-8.1%	8.8%
Excess Return	-0.6%	6.3%	2.9%
<b>Class C (Hedged - base fee option)</b> Inception 28 September 2018			
<b>Portfolio return (AUD) - Net of all fees</b>	<b>-15.5%</b>	<b>-8.7%</b>	<b>8.7%</b>
MSCI AC World Accum Index ex-Australia 100% Hedged (AUD)	-14.4%	-13.8%	4.8%
Excess Return	-1.2%	5.1%	3.9%

\*Past performance should not be taken as an indication of future performance.

## MARKET AND PORTFOLIO PERFORMANCE

The international equity market, as measured by the MSCI AC World Accumulation Index ex-Australia, declined by 7.8% in the quarter (all returns are in A\$ unless stated otherwise). Equity markets fell by 13.7% in local currency terms, with changes in foreign currencies adding 5.9%.

The Aoris International Fund (Class A - Unhedged) declined by 8.4% in the quarter, 0.6% behind its benchmark, while the Aoris International Fund (Class C - Hedged) declined by 15.5%, underperforming its benchmark by 1.2%.

During the quarter Nike and Experian both declined by approximately 17%, detracting 1.2% and 1.0% from fund performance respectively. No other stock held over the quarter declined by more than 10% or detracted more than 0.8% from fund performance.

The complexion of the market in the June quarter looked much like the prior quarter, with Energy the best-performing sector, up by 3.5%, and Information Technology the worst, with a fall of 14.5%. Over the six months to June, the difference in performance between the two sectors is a stark 47.1%.

The twin externalities that unnerved financial markets in the March quarter - rising inflation and tightening monetary policy - became more confronting in the June quarter. Inflation in the US, as measured by the CPI, rose from 8.0% yoy in March to 8.6% three months later, while the US Federal Reserve increased official rates by 1.25% in the June quarter, compared to just 0.25% in the three months to March. The higher cost of living has begun to have a progressively more meaningful impact on consumer spending and confidence, raising the prospect of a recession.

It is natural for investor sentiment to rise and fall with the economic tides. To extend the analogy, it is true that some corporate boats appear to be moving forward when the tide rises and the winds are favourable, only to go into reverse as the tide recedes. They simply ebb and flow, going nowhere over a full cycle. Other businesses are fragile and get dashed on rocks as the economic storm surges, perhaps suffering lasting damage, or at least requiring a great deal of resources to be spent to make the vessel seaworthy again after the storm recedes.

A different group of businesses, though, are built to withstand the most adverse conditions; let's call them all-weather businesses. They are captained and crewed by hardened hands who have experienced severe weather many times before and understand that adverse conditions are inevitable but never permanent. At Aoris, these are the businesses we seek to own.

Over the June quarter, 13 of our 15 portfolio holdings reported results consistent with or exceeding our expectations. These included:

- Jack Henry, which is a provider of a variety of essential software solutions used by small banks and credit unions in the United States. Revenue in the March quarter rose 7% yoy, with a slight improvement in profit margins on an underlying basis.
- Halma, which supplies niche industrial products into three markets globally – health care, environmental and safety – reported underlying revenue growth in the six months to March of 12%. Profit margins were lower yoy, reflecting the benefit a year earlier of temporary cost reductions, but in line with our expectations.
- Amphenol, which supplies electronic connectors and sensors into a wide variety of end markets globally, reported an excellent March quarter, with underlying revenue growth of 17% and slightly higher profit margins.
- Experian supplies credit data, analytics and decisioning software to banks and other lending organisations globally. Its revenue in the three months to March rose 9% yoy, with increased profit margins.

Of course, operating conditions for these businesses may prove more challenging in the quarters to come and growth may be slower than was the case in their most recently reported period. For each of these companies we have been impressed by not only their revenue and earnings growth, but also their success in widening the competitive gap with their peers. Furthermore, we have been pleased with the long-term decisions that management has taken during a less favourable period, which we believe enhances the value of these businesses.

The two businesses whose most recent results or outlook fell short of our expectations were Nike and Moody's.

- Nike reported results for the year ended May with revenue growing organically by 6% and profit margins lower yoy, reflecting challenges such as lockdowns in China and higher transportation expenses. The company's outlook for the year ahead is for strong revenue growth but lower margins than we had expected, attributable mostly to ongoing elevated shipping costs. Our view of Nike's long-term earnings prospects has not changed, although it will take longer to achieve them. We were pleased that, despite sustained inflation headwinds, Nike continues to grow its investment behind its brand, e-commerce, stores and IT systems, to support the long-term value of the business.
- Moody's has benefited from a buoyant credit cycle to a larger degree than we had previously appreciated. Following a weak March quarter result, we revised down our mid-cycle earnings estimate and valuation, and sold Moody's from the portfolio. We provide more details on this in the following section.

# Portfolio changes

## PURCHASES

### Microsoft

Microsoft has long-established, dominant positions across an array of corporate and personal computing. Its products include the Office productivity suite of applications; Windows, the operating system inside the majority of the world's laptops and PCs; Azure, where Microsoft provides applications and computing infrastructure via the cloud; the professional social network LinkedIn; Xbox video gaming; and Surface laptops. In our view, Microsoft has become a stronger, more relevant and more durable business over the last several years by building Azure into a leading cloud services provider and successfully transitioning its operating system and applications to the cloud. Delivered via the cloud, applications such as Office 365 are more valuable to the user, can be more frequently updated, and lend themselves to feature innovations, a visible example being Teams. The cloud ties Microsoft's offerings together more cohesively, deepens its relationship with enterprise customers, and makes them more relevant to new user groups, such as small businesses and front-line workers.

Recognising the improvement in quality of the business, we took advantage of a de-rating in its valuation to establish a portfolio position in Microsoft during the quarter.

## SALES

### Moody's

We sold our position in Moody's (it was the second-smallest position in the portfolio) due to concerns regarding the quality and strategic direction of the Moody's Analytics (MA) segment, which accounts for 40% of group revenue, as well as the cyclicity of Moody's Investor Services (MIS), the credit rating agency. MA comprises a collection of data and software used by banks to assess risk. Management appears to have taken a very broad definition of the risk markets they wish to participate in, and in 2021 it acquired RMS – a catastrophe risk assessment business whose data is used by property insurance companies – for \$2 billion, Moody's second largest-ever acquisition. We are concerned by the risk of further strategic drift away from the company's core markets, which we see as risk assessment services for banks and, to a lesser extent, life insurance companies. MIS's revenue has benefited from ultra-low interest rates in the last few years to a larger extent than we had previously appreciated. Adjusting our mid-cycle earnings to reflect this, the valuation was less attractive, and we exited the position.



*This feature article was  
written by Delian Entchev,  
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# The lasting impacts of market sell-offs

## INTRODUCTION

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Periods of sharp share price falls are a regular feature of equity markets. Their timing isn't predictable, but their occurrence is inevitable.

Even if we are prepared to encounter market sell-offs, they can be a trying period for any investor. Objective, long-term investment decisions are difficult to make under the best of circumstances, let alone when investors are faced with war, an ongoing pandemic, the highest inflation in 40 years, and any subsequent impact on their personal lives.

What investors should do with their portfolio also depends on what businesses they own, and how they may be affected by the events that are causing the sell-off. Not all businesses will come through 2022's challenges unscathed.

In this feature article, we discuss two ways in which market sell-offs can have lasting impacts that compromise investors' long-term outcomes:

- Their impact on investors' behaviour; and
- How they affect the fundamental performance of individual businesses.

We then consider how winning businesses can use market sell-offs to their advantage, and conclude by sharing what gives us confidence in our portfolio holdings during the current market decline.

## INVESTOR BEHAVIOUR DURING FALLING MARKETS

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*An emotional response to falling share prices can turn a transitory loss into a permanent one.*

In hindsight, every past market crash looks like a clear buying opportunity, but in the moment it's discomfoting to see the value of one's investments decline.

The stress associated with falling share prices can amplify investors' existing emotional biases and inhibit their ability to make rational investment decisions. This can turn any transitory impacts of the sell-off into a permanent loss of capital.

As humans we're all susceptible to these biases, but we can improve our odds of success by acknowledging them and understanding how they could compromise our investment outcomes. Below, we outline four common investor behaviours that are exacerbated by market sell-offs.

1. Rising asset prices provide investors with seemingly confirming evidence that their strategy is working. As their portfolio value declines, they can **lose confidence** in what they own and then sell out in a panic at the least opportune time.
2. Investors' **time horizon compresses** and they can lose sight of their long-term objectives. It may feel like the world will never return to the way it was before the crisis at hand, or that the gloomy conditions of the present will extend far into the future.
3. Investors may be tempted to **time the market** by selling their equity holdings and waiting to buy back at cheaper prices. But it's impossible to know how long it will take for the market to bottom, and difficult to muster the courage to buy back into the market amid ongoing negative sentiment and news.
4. In the face of uncertainty, investors may **seek precise answers** to the future performance of their portfolio even when they don't exist. For example, by relying on expert opinions like sell-side analysts, even though they have no better predictive ability than the rest of us. Or they may look to history as a guide for the challenges of today, as market commentators are currently drawing parallels to the high inflation of the 1970s, even though the world looked very different back then.

Investors with a long-term mindset who have confidence in what they own are more likely to 'stay the course' and take advantage of valuation dislocations to add to their investments during a sell-off.

## HOW FALLING SHARE PRICES AFFECT INDIVIDUAL BUSINESSES

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*A market sell-off can have lasting negative impacts on businesses.*

Market sell-offs can also be a trying time for businesses, to varying degrees. For some, their falling share price will have little bearing on their long-term prospects. For others, the changing external conditions in 2022 will have lasting negative impacts.

In this section, we focus on three challenges that a market sell-off can present to individual businesses.

### 1. Speculative business activity

Ebullient market conditions encourage risk-seeking behaviour from investors. They are more willing to underwrite new, speculative businesses with expected pay-offs far into the future.

When a company's shares are trading strongly it has credibility with investors and can raise capital from them. It receives lots of media attention, which is effectively free advertising. It can attract talented people and management, who are then motivated to turn the narrative into reality. In other words, a rising share price can manifest a company's success even if it had no sustainable business model to begin with.

A recent example is movie theatre chain AMC, which was deeply lossmaking and highly indebted coming into the COVID-19 pandemic. The company was given a new lease of life by retail shareholders who speculated on its shares in 2021, allowing it to raise equity at elevated prices. Management has used the proceeds to acquire other movie theatre chains, but the business remains unprofitable.

Market sell-offs can be a catalyst for exposing unsustainable business practices that were normalised during periods of investor optimism. As the famous Warren Buffet quip goes: "You don't find out who's been swimming naked until the tide goes out."

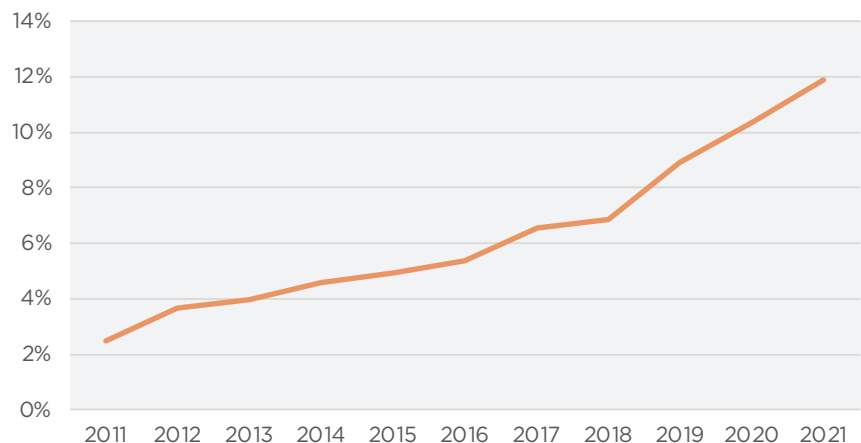
Investors lose their appetite as the reality of their poor financial picture sinks in. They demand to see profits, which involves cost and headcount reductions. Media coverage falls as the shine wears off. All of this is to the benefit of their established, well-funded competitors who see a more rational competitive landscape.

## 2. Reliance on share-based compensation

Some companies issue shares to employees as part of their compensation. This is also a common incentive mechanism for executives, to align them with shareholders' interests.

The practice is especially popular in high-technology industries where there is a fierce war for talent, and early stage or unprofitable businesses that can't afford to pay competitive salaries in cash. The rise in popularity of share-based compensation has coincided with a 10-year bull market for technology businesses. For example, the figure below shows a steady increase in share awards to employees at the average US software company.

### Share-based compensation as a % of sales for US software companies



Source: FactSet, Aoris analysis

Many companies present alternative profit measures that exclude share-based compensation, arguing that it is a non-cash expense. Not only does this mislead investors about the true economics of the business, but it also understates the risks of compensating employees in this way.

Employees are more than happy to receive the shares as long as they're appreciating in value, but in a market sell-off they discover that the value of what they've been earning might be less than they thought. If the shares fall by 50%, which has been the case for many technology companies in 2022, that's a steep pay cut for the employees. It can also be a distraction and shake employees' confidence in the company's future.

The company then has three unenviable choices:

- Award more shares to each employee to make up for the fact that each share is now worth less, which dilutes the interests of other shareholders.
- Pay employees more in cash rather than shares – at significant cost to the business – which highlights the fallacy that this is a non-cash expense.
- Inaction, at the risk of employees leaving and then finding it more difficult to hire.

Staff retention is a particularly important challenge for many businesses in 2022, as they face labour shortages and inflation. Companies that have leaned heavily on share-based compensation are likely finding it more challenging and costly to compete for talent.

### **3. Weak balance sheet**

Unprofitable businesses and those with high levels of debt rely on continued access to capital markets to sustain themselves. In a market sell-off where credit availability tends to tighten, their ability to refinance their debt may be called into question, and creditors will require more attractive terms.

If the sell-off is accompanied by a rise in interest rates, as is the case in 2022, then highly indebted businesses are further burdened by increasing interest costs.

Businesses under severe financial stress may be forced to raise new equity, which dilutes the ownership of existing shareholders.

Businesses with weak balance sheets are also less well positioned to address the challenges that have caused the market sell-off. One such example is Revlon, one of the largest beauty companies in the world, which competes with Aoris portfolio holding L’Oréal. Last month Revlon filed for bankruptcy after struggling for many years to bring its high debt levels under control. Its management conceded that peers with stronger balance sheets were better able to navigate the recent inflation and supply chain challenges:

*“Because many of the company’s competitors have more cash on hand, they have been able to build more inventory in advance, invest in stocking up on components and raw materials, and pay up front or a premium where needed to secure additional supplies.”*

*Most companies that experience an 80%+ drawdown never recover the loss.*

### **The likelihood of recovering severe price falls**

To test our hypothesis that sharp share price falls can have lasting effects on businesses, we studied the A\$ returns, including dividends, of the largest 4000 companies over the last 20 years.

Of these companies, 600 have experienced a drawdown of 80% or more. After the decline:

- 74% never recovered to their initial price
- 36% of them are still trading 80% or more below their peak price
- 16% went bankrupt.

During the first half of 2022, dozens of high-flying and mostly unprofitable businesses are down by 80% or more, including the likes of Carvana, Shopify, Affirm and Coinbase. History suggests that they're more likely to remain fallen angels than to reclaim their glory.

## **MARKET SELL-OFFS PRESENT OPPORTUNITIES FOR WINNING BUSINESSES**

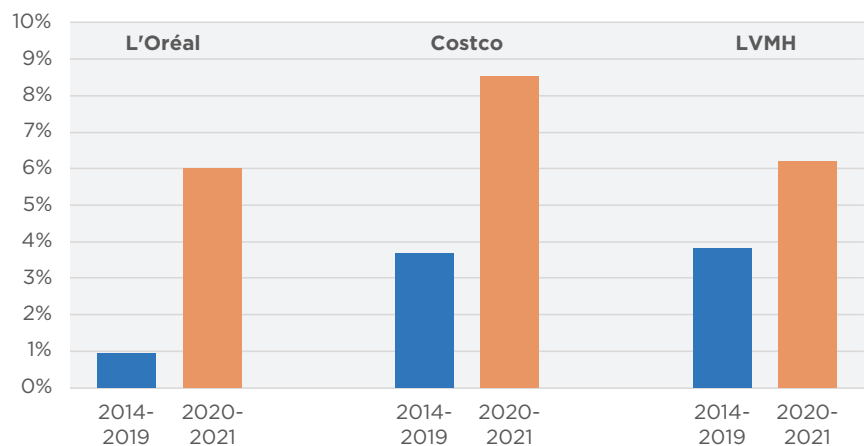
*Winning businesses widen their competitive lead during market sell-offs.*

Conversely, great businesses have deep-rooted competitive advantages that become even more important and visible in times of stress. They have outlasted and outgrown their competitors over many years and through different market environments. They have always adapted to external changes and threats.

In a period of heightened uncertainty, when many companies cut their investment spending to protect near-term profits, a longer-term mindset and robust balance sheet can be invaluable. A willingness to stay the course and continue to recruit, pay employees well, invest in its brand and product innovation, and go out of its way to help clients, can pay off enormously for a business in the ensuing years. Market sell-offs tend to be opportunities for winning businesses to further widen their lead over competitors.

We can see this phenomenon exhibited in three companies held in the Aoris portfolio - L'Oréal, Costco and LVMH - each of which accelerated their market share gains over the last two years. The chart below shows by how much the organic growth of each business exceeded the growth of their end market.

**Annual outperformance in growth vs. company's end-market**



Source: Company data, Statista, Aoris analysis

Businesses with a conservative capital structure will also be more able to take advantage of market conditions during a downturn. For example, to make opportunistic acquisitions or share repurchases as valuations become more attractive.

**WHAT GIVES US CONFIDENCE DURING THE 2022 MARKET SELL-OFF**

In the Aoris International Fund we own 15 proven and leading companies that have navigated all manner of challenges through their long operating histories.

Our portfolio companies are profitable, have been resilient through prior market cycles, and are managed with a long-term mindset and conservative balance sheets. For instance, a third of global companies with a market capitalisation of over A\$3 billion have lost money in at least one of the last 10 years, whereas none of our portfolio companies have.

They are also good places to work, offering attractive wages and opportunities for career progression, which has held them in good stead through the recent labour shortages.

We recognise that our portfolio companies are not immune to the external environment and that their earnings may be affected if economic conditions worsen. But we are encouraged that through the recent market volatility they continue to make growth investments and improve their customer proposition. We expect our portfolio companies to be competitively stronger and more valuable five and ten years from now.

We always look to own this sort of business rather than try to change the portfolio to suit the market environment. Staying fully invested, i.e. not having to take a view on the direction of markets, lets us focus on assessing the performance of what we do own. Owning fewer high-quality businesses that we know well gives us confidence to stay the course with our investments through a downturn.

Last but not least, we aim to be as transparent as possible with our investors, including disclosing all our portfolio holdings every month, so they can make their own informed decisions about the place of our fund in their portfolios.

## IN SUMMARY

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This has been a challenging year for both investors and businesses. It's natural for falling share prices to induce an emotional response from investors, which can impede sound investment decision-making. A market sell-off can also have lasting negative impacts on businesses with unsustainable economics, weak balance sheets or a high reliance on share-based compensation.

On the other hand, great businesses tend to shine in times of stress. They adapt to the changing conditions and continue to invest towards becoming competitively stronger. Their long-term minded management and conservative balance sheets allow them to take advantage of falling valuations through opportunistic acquisitions or share repurchases.

These high-quality characteristics are common among the 15 businesses we own in the Aoris International Fund, giving us a high degree of confidence to stay the course with our investments during market sell-offs.

# Stock profiles

## EXPERIAN

*Experian is the largest credit bureau in the world, with loan repayment data on over 1.4 billion people and 191 million businesses.*

Based in the UK, Experian is a global data and analytics company, with particular geographic strength in the US. At Experian's core, and accounting for around 30% of revenue, are the credit bureaus that it operates in 23 countries. Credit bureaus are used by banks to make lending and loan-pricing decisions.

A credit bureau operates as a contributory database under which banks supply data to the bureaus on every loan and every principal-and-interest payment at no charge. Completeness is key – if a bureau doesn't have data on every account from every bank, it will miss loans on individuals who borrow from multiple banks. Bureaus complement bank-sourced loan repayment data with many publicly available sources of data as well as proprietary information. For example, Experian can build a more complete credit profile of an individual through exclusive access to a rental payments database, utility payments or even streaming TV subscriptions.

Credit bureaus are natural oligopolies – the US has three bureaus and most other countries have two. The barriers to entry are extremely high in the form of trust, reputation and data-handling capabilities.

What makes Experian a particularly interesting business and far more than just a credit bureau is its ability to combine data with advanced analytics. One such example is Ascend, which helps clients interrogate their markets to inform their product design strategy, customer acquisition and pricing. Ascend gives clients real-time access to Experian's credit data in an anonymised form, which in the US covers 18 years of data on 220 million Americans. This can be combined with third-party data as well as the client's own data. Customers can perform very granular analysis, such as "What is the default rate on auto loans for customers in this age and income bracket in this zip code?" Experian management asserts that no competitor has an offering comparable to Ascend, which is growing rapidly and becoming a material contributor to group revenue.

A second interesting business Experian has developed is its consumer marketplace. If you've ever been on a price

comparison website, looking to renew your car insurance or refinance your mortgage, you'll recall how frustrating it can be to have the site tell you how much you'll save at the beginning of the process, only to then spend time submitting detailed information and have those 'offers' disappear. Experian has a global consumer membership base of 134 million and rising, who give Experian permission to access their credit data and based on this information, are given pre-approved credit and insurance offers. This is a large business for Experian today, with a significant opportunity ahead of it.

We see Experian as a high-quality business that has become a better business in recent years and has many years of attractive growth ahead.

## HALMA

*Halma has always self-financed its investments, which makes it a resilient business in the face of macroeconomic uncertainties.*

Based in the UK, Halma is a collection of industrial companies with a core focus on safety, health and the environment. Its products include instruments that detect flammable and hazardous gases, explosion-protection devices to protect pressurised vessels and pipes, fire detection and suppression systems, elevator door safety sensors, and surgical instruments to assess eye health and assist with eye surgery.

Most of Halma's markets are underpinned by regulation, which creates high barriers to entry, drives sustained demand throughout economic cycles, and often makes customers' spending non-discretionary. Halma focuses on creating strong leadership positions in the most attractive niches within these markets.

Halma was established in 1972, beginning life in the lead-up to a period of excessive inflation and a tight lending environment. Consequently, management has always self-financed its investments, which created a resilient business in the face of macroeconomic uncertainties. Halma has also maintained consistently high gross margins of over 60%, which lessens the extent to which it needs to increase prices to customers in order to offset product cost inflation.

Halma has an active bolt-on acquisition strategy that has delivered value to shareholders. It purchases businesses that are

typically private, family-owned and operating in markets that Halma is already familiar with. Halma develops relationships with acquisition targets for years before the deal, which means it has less competition and can pay low multiples of 10-11x operating profit. Once a business is acquired, Halma can leverage existing infrastructure and operations to drive accelerated growth and expansion opportunities, unlocking further value.

The above attributes have allowed Halma to grow organically by 6-7% over the last 10 years, at stable margins. It has delivered consistent double-digit EPS growth and 43 consecutive years of dividend growth of 5% or more. We expect it to deliver similarly attractive financial outcomes going forward.

## Get in touch

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**A COMMONSENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE**

### Important Information

This report has been prepared by Aoris Investment Management Pty Ltd ABN 11 621 586 552, AFSL No 507281 (Aoris), the investment manager of Aoris International Fund (Fund). The issuer of units in Aoris International Fund is the Fund's responsible entity. The Trust Company (RE Services) Limited (ABN 45 003 278 831, AFSL Licence No 235150). The Product Disclosure Statement (PDS) contains all of the details of the offer. Copies of the PDS and target market determination are available at [aoris.com.au](http://aoris.com.au) or can be obtained by contacting Aoris directly.

Before making any decision to make or hold any investment in the Fund, you should consider the PDS in full. The information provided does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial adviser if necessary.

You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.