

# AORIS

## Quarterly Report



# Aoris Investment Management

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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.

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## The Aoris International Fund

We own a concentrated portfolio of high-quality, wealth-creating businesses run by prudent and capable management. Owning a maximum of 15 companies allows our quality criteria to be unusually demanding and permits us to be discerning on the price we pay. We aim to deliver a return of 8–12% p.a. after fees over a 5–7-year market cycle.

# Aoris International Fund

## Performance to 30 September 2023

<b>Class A (Unhedged – base fee option)</b> inception 26 March 2018	<b>September Quarter</b>	<b>1 Year</b>	<b>Since Inception p.a.*</b>
Portfolio return (AUD) net of all fees	-3.4%	24.9%	14.1%
MSCI AC World Accum Index ex-Australia (AUD)	-0.4%	20.5%	10.3%
Excess return	-3.0%	4.4%	3.8%

<b>Class C (Hedged – base fee option)</b> inception 28 September 2018	<b>September Quarter</b>	<b>1 Year</b>	<b>Since Inception p.a.*</b>
Portfolio return (AUD) – net of all fees	-5.6%	20.8%	10.2%
MSCI AC World Accum Index ex-Australia 100% Hedged (AUD)	-2.8%	18.1%	5.9%
Excess return	-2.9%	2.7%	4.3%

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

## Market and portfolio performance

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International equity markets, as measured by the MSCI AC World Accumulation Index ex-Australia, declined by 0.4% in the September quarter (all returns are in A\$ unless stated otherwise). Equity markets declined 2.8% in local currency terms, while changes in currency values added 2.4% to the A\$ return.

As shown in the table on the previous page, the Aoris International Fund (Class A – Unhedged) declined by 3.4% for the quarter, underperforming its benchmark by 3.0%. The Aoris International Fund (Class C – Hedged) declined by 5.6% for the three-month period, underperforming its benchmark by 2.9%.

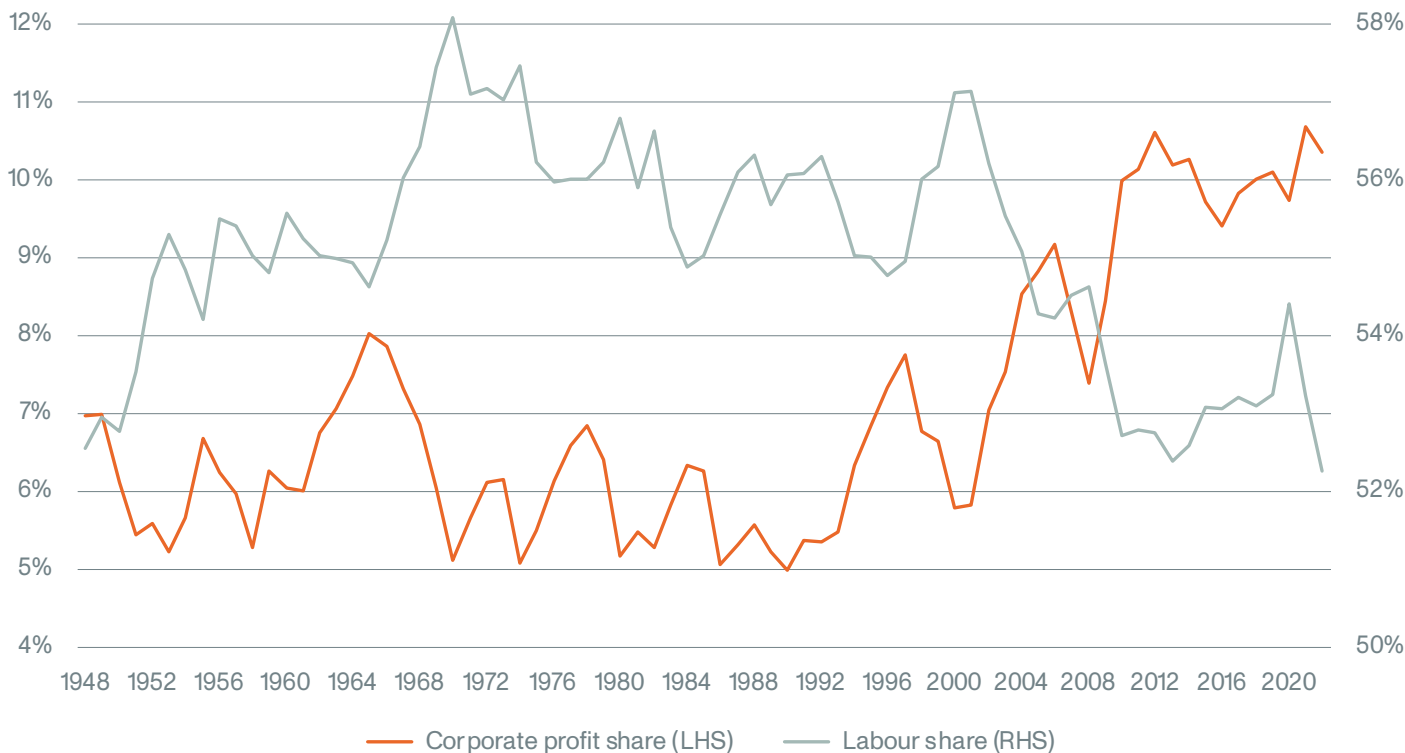
A feature of financial markets over the quarter was the rise in long-term government bond rates in many countries, to the highest level in more than 15 years. This will increase debt servicing costs for governments, households, and businesses. In this environment we believe it's particularly important for investors to own businesses with strong balance sheets. For the Aoris portfolio, the average ratio of net debt to earnings before interest, tax and depreciation is 0.5x, which compares to an average of 2.2x for the 500 largest US companies. No company in the Aoris portfolio has a debt ratio above 3x.

## Labour market tension and what it may mean for corporate earnings

In recent months we've read about striking workers across a variety of industries in the US, including logistics (UPS), automotive, entertainment (Hollywood scriptwriters) and healthcare. According to data from Cornell University, the number of US workers involved in strike action in the first nine months of 2023 was more than double the number in the comparable period of 2022, and three times that of 2021. A key demand in every strike event was, naturally, higher pay. Given that labour is the largest cost item for most companies, this bears paying attention to.

The chart on the next page shows that in 2022 the share of US economic wealth (as measured by GDP) accruing to labour as wages and salaries fell to its lowest level in at least 75 years. It's no wonder that workers are striking in large numbers. Conversely, the share of GDP accruing to corporate profits, which tends to move in the opposite direction to labour share, was close to a record high.

Corporate profit and labour share of US GDP



Source: Bureau of Economic Analysis

There are many causes of the declining share of the economic pie accruing to workers over the last 20 years or so. Two important ones are:

- **Globalisation** – mass urban migration in both China and India dramatically increased the pool of low-cost workers. Freer international trade has meant these workers compete more effectively with global labour markets across a wide range of manufacturing and service industries. Offshoring and outsourcing to low-cost countries have placed downward pressure on wage rates in Western nations, including the US.
- **De-unionisation** – trade union membership as a percent of the US full-time workforce has fallen from 15% in 1988 to 10% today. Interestingly, over the same period union representation in Australia has fallen from 47% to 13%. Fewer workers benefit from collective bargaining by their unions, shifting the balance of power in favour of employers.

Corporate earnings have clearly benefited at the expense of labour over the last two decades. Might the pendulum now move in the opposite direction? There are two factors to consider here:

- **Deglobalisation** – the last few years have seen greater sensitivity from Western companies around their supply chain risks, and in particular their dependence on China. This is resulting in an onshoring of manufacturing work back to the US and Europe, with encouragement from government incentives. Further, wage rates in China have increased at a much faster rate than in developed countries, diminishing their relative cost advantage.
- **Demographics** – the US working age population has increased by 20 million (or 15%) since 2000, but is expected to grow by just 5% in the next 23 years, according to the OECD. In Europe the picture is even less favourable, where the working age population is expected to shrink by 5% by 2046. With unemployment rates close to record lows today in most developed countries and a limited growth in the supply of workers in the years ahead, economic growth will strain labour markets.

The combination of deglobalisation and demographics may place upward pressure on wage costs and redistribute the economic pie in favour of workers at the expense of corporate earnings.

We are mindful of the risk of higher labour costs for companies in the Aoris portfolio. But with change comes opportunity. We own several businesses that provide a valuable role in helping their customers outsource tasks that would otherwise be more expensive to do themselves. This includes Accenture in IT outsourcing and Fastenal in inventory management. Microsoft reports that for customers whose software developers are using its Copilot artificial intelligence (AI) tool, half their code is now being written by Copilot.

Copart, the leading auction platform for salvaged vehicles in the US, is another interesting example. Its insurance company customers are increasingly outsourcing to Copart manual processes – such as obtaining legal title to the vehicle being sold – as insurers struggle to hire people to perform these tasks in the current tight labour market.

## Portfolio Changes

None



# What can driving teach us about business growth?



Written by Alfred Tadros,  
Portfolio Manager

## Introduction

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The risk of disappointment is higher for businesses that grow too slowly or too fast.

Investing can be like driving. If you drive your car or grow your business too slowly, you get overtaken by your peers. If you drive or grow too fast, you run the risk of an accident. In between, there is a safe cruising speed to navigate most conditions.

Growth is an important ingredient in our assessment of a company's quality and risk. In this feature article, we explain why the risk of disappointment is higher for businesses that grow too slowly or too fast, and share how we determine the appropriate growth rate for the companies we invest in.

We focus on organic revenue growth, which excludes the contribution of acquisitions to a company's growth. We see this as a good measure of the health of a business and its relevance to its customers and the economy at large. Businesses can grow organically by winning new customers and by selling more products and services to their existing customers.

## Stall speed – why slow-growing businesses get left behind

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It's difficult for businesses to create wealth for their shareholders if they're not keeping up with the growth of the broader economy or their peers.

Businesses that don't grow at least as fast as the global economy are at risk of fading into obscurity. Over many decades the global economy has grown by around 3% p.a., as measured by global Gross Domestic Product, so this is our minimum threshold for growth.

In a similar vein, if a business consistently grows slower than its industry and direct competitors, then it's losing relevance to its customers. Even if it operates in a fast-growing market, simply growing at the same rate as its peers isn't special. We look for businesses that consistently outgrow their peers, which means they are competitively winning, and customers value and distinguish their products and services.

What happens to companies that grow slower than the economy or their peers?

### **1. They may find it difficult to avert their loss of corporate and customer relevancy**

Slow-growing companies may be less able to increase their spending on new product development, marketing, and their people. These are all investments that help businesses develop and retain their relevance with customers. A lack of investment is likely to consign low-growth businesses into a vicious cycle where they continue to lose market share to competitors and fade into irrelevance. This only worsens the longer that the low growth persists.

Even if they do manage to reinvigorate their growth, it may take even longer to repair their reputation as a laggard in the eyes of customers.

## 2. They may struggle to attract and retain talent

The best job candidates want to work for growing, successful companies with opportunities for career advancement. Growing businesses with a leading market position can attract the highest calibre people, while employees at slow growth companies may look for opportunities elsewhere if their career progression is limited. Low growth companies tend to experience higher levels of employee turnover, and all the associated business disruptions.

## 3. They may be tempted to engineer profit growth through cost cutting and large acquisitions

In the absence of acceptable organic growth, management teams might resort to cost cutting and restructuring to drive profit growth. But you can't cost cut your way to glory. There are limits to how far businesses can cut costs before it affects the quality of their products and services, and impairs their ability to grow even further.

In search of growth companies may also make large, transformative acquisitions, which have historically low probabilities of success and a high risk of business disruption. We wrote about this subject in our [June 2021 quarterly](#).

IBM over the last 20 years is a great case study on management's temptation to engineer earnings growth through massive cost cutting, share repurchases, and large acquisitions.

It's difficult for businesses to break the cycle of slow growth and irrelevance.

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## High octane – fast growth is difficult to sustain

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At the other end of the spectrum, rapid growth can be just as dangerous to a company's long-term health. The light that shines twice as bright usually lasts half as long. Why might this be the case?

The risk of strategic missteps increases as a business chases high growth. Management may impose unrealistic expectations on their people internally, resulting in decisions that drive growth in the short-term but prove to be damaging to the long-term health of the business. For example they may bring new products to market that miss the mark, sign sales contracts at low margins, or seek out new markets where the company's competitive advantages are not apparent.

Fast growth places a great strain on the internal operations of a business – think basic functions like product development, sales, and finance. It becomes difficult to find the right people, train them and manage them when working at high speed. Businesses that deal in physical goods also need to invest in physical infrastructure like warehouses and stores to support their growth. Rather than keeping pace with the necessary level of investment in their operations, fast-growing businesses may find themselves in a perennial state of catch-up.

An additional risk is our ability as investors to make good decisions about a high-growth business. We may overestimate the sustainability of its high growth rate, and hence overvalue the business. We may also overstate the quality of a business and the value it provides to its customers simply because it is growing so fast. The share market tends to be unforgiving when fast-growing businesses decelerate – not only does it reprice their long-term earnings potential, but it also ascribes them a lower valuation multiple.

Fast growth increases the likelihood of poor decisions by company management and as investors.

Some companies do manage to grow persistently at 15% or more but they are rare. We studied the growth of the 5,000 largest companies in the world between 2011 and 2020. Only 5% of them grew at an average rate of 15% or more over this period, and only 2% grew by 20% or more.

Fast-growing companies often have a good story to tell, garnering excitement from investors. However the chances are higher that rapid growth today is followed by a long period of slow or no growth, rather than the fast growth persisting.

These fast growers tend to be found in young, competitively unstable markets where the winners are yet to be decided, and where even the size of the market is yet to be determined. In an established business, the value of its product or service to its customers is no longer up for debate.

A 2014 McKinsey study titled *Grow fast or die slow* analysed the lifecycle of 3,000 high-growth software and internet companies between 1980 and 2012. Only 3% of the companies, 90 out of 3,000, ever achieved revenue of US\$1 billion or greater once they became publicly listed. McKinsey found that the main reason fast-growing private companies fail to sustain their growth as public companies is difficulty in developing past their first act.

They were far less successful in penetrating new markets and sales channels, and less successful with their next new products.

While we read a lot about success stories like Amazon, Google and Facebook, the reality is most high-growth companies fail to develop an enduring customer proposition and sustain their growth.

## Our ideal cruising speed

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As a minimum, we expect our portfolio companies to grow organically faster than 3%, which is an approximate rate of growth for the global economy, and faster than the markets in which they operate.

We have no explicit ceiling on organic growth, but we do think twice when assessing businesses that have been growing at double-digit rates, and whether that rate of growth is likely to sustain. We recognise that there is a wide range of outcomes with fast-growing businesses, and the risk of us misjudging their quality or valuation is high.

We look to history as a guide when determining the appropriate long-term growth rate of a business. It's easier to be confident a company will grow organically by 4% going forward if it has grown at that average rate for the last 10 years, but less so if it's only grown at 2% for the last 10 years. There would need to be a clear, fundamental change to the business for us to assume the future will look better than the past.

We also recognise that businesses don't evolve linearly. They are subject to the ups and downs of their industries and customers. We don't expect our portfolio companies to grow at the same rate every year, or even to report positive organic growth every year. But even when their industry is in a downturn, we do expect them to outgrow their peers by virtue of their longstanding competitive advantages.

We assess a company's growth prospects on average through an economic cycle, with at least a 5–7-year horizon. We generally expect our portfolio companies to grow organically by 3–10% over a market cycle, which we consider our ideal cruising speed.

More important than the level of growth is its durability, and our confidence in a company's ability to sustain its growth over the long-term. This is why we look for industry-leading businesses that gain market share due to clearly identifiable, deep-rooted competitive advantages, and which operate in competitively stable markets where the risk of disruption is low.

We generally expect our portfolio companies to grow organically by 3–10% over a market cycle.

Conclusion

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The level and durability of a company's organic growth is a crucial input into our assessment of its quality and risk, and its ability to create enduring wealth over a market cycle.

We focus on finding businesses that grow faster than the global economy, faster than their peers, and at a rate that is sustainable. Slow growth risks a company fading into irrelevancy and tempting management into bad decisions. Fast growth, on the other hand, is statistically unlikely to sustain and may be a sign of an immature market where the winners are yet to be determined.

Portfolio companies

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The logo for Accenture, featuring the word "accenture" in a lowercase, sans-serif font with a small chevron symbol above the 'e'.The logo for Amphenol, consisting of the word "Amphenol" in a bold, sans-serif font.The logo for Cintas, featuring the word "CINTAS" in a bold, sans-serif font with the tagline "the uniform people" in a smaller font below it.The logo for Costco, featuring the word "COSTCO" in a bold, sans-serif font.The logo for Graco, featuring a stylized "G" icon followed by the word "GRACO" in a bold, sans-serif font.The logo for Halma, featuring a stylized "H" icon followed by the word "Halma" in a bold, sans-serif font.The logo for Fastenal, featuring the word "FASTENAL" in a bold, sans-serif font.The logo for L'Oréal Paris, featuring the words "L'ORÉAL" and "PARIS" in a serif font.The logo for LVMH, featuring the letters "LVMH" in a serif font.The logo for Microsoft, featuring a four-square icon followed by the word "Microsoft" in a sans-serif font.The logo for Relx, featuring a stylized "R" icon followed by the word "RELX" in a bold, sans-serif font.The logo for Tractor Supply Co, featuring a stylized "TSC" icon followed by the words "TRACTOR" and "SUPPLY CO" in a bold, sans-serif font.

# Stock profiles

## RELX

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RELX is a global leader in content, analytics and decisioning tools for professional customers in three primary markets: scientific research, legal practices, and risk services. In each of these three markets, end-demand growth is healthy. The value RELX provides to its customers supports very attractive profit margins, and the barriers to new entrant competition are unusually high. As it is today, we view RELX as a high-quality business.

Making RELX particularly interesting to us is its gradual evolution to become an even better business. It is shifting from selling lower growth basic data and content, to higher growth and even more profitable analytics and decisioning tools. As a result, underlying revenue growth is steadily rising and doing so in a consistent and durable fashion.

RELX is the world's leading publisher of peer-reviewed academic journals, accounting for around 18% of global research output. Of the 225 science and economics Nobel Prize winners since 2000, 224 have published in its journals. From this foundation of data and a deep understanding of its customer needs RELX sells faster growing analytic and decisioning tools. Examples include helping academic institutions in their allocation of research funding, finding the right chemical compound for a drug in development, and helping a healthcare provider choose the right oncology pathway for a patient.

In legal publishing, RELX is one of two leading providers globally. From its strong market position and deep data assets, RELX sells faster-growing analytic and decisioning tools. It offers tools to help lawyers more efficiently draft legal documents; and to help litigators develop their strategy, analyse the strength of their legal arguments, and choose the right expert witnesses.

RELX is gradually becoming an even stronger, faster growing and more profitable business.

RELX's third business area is risk products, where it sells to a range of industries. For instance, its tools help insurance companies assess and price their policies. RELX is also a global leader in fraud mitigation and identity verification tools, which are used by the likes of banks and government agencies. Growing use of e-commerce, online banking, and online access to government services is driving strong growth in this business.

Tying together RELX's three primary markets is data. RELX's ability to access, collate, safely store and extract useful information from its vast quantities of data is a core capability. In fact, one-third of the company's employees are technologists. RELX has a long history of using AI and machine learning to extract the most value from its data. Recent advances in AI hold exciting potential for RELX as a data-intensive business.

We see RELX as a strong and highly profitable business, gradually becoming a stronger and faster growing one as analytics and decisioning tools make up an increasing proportion of its activities.



## CDW

CDW is larger than its next four competitors combined.

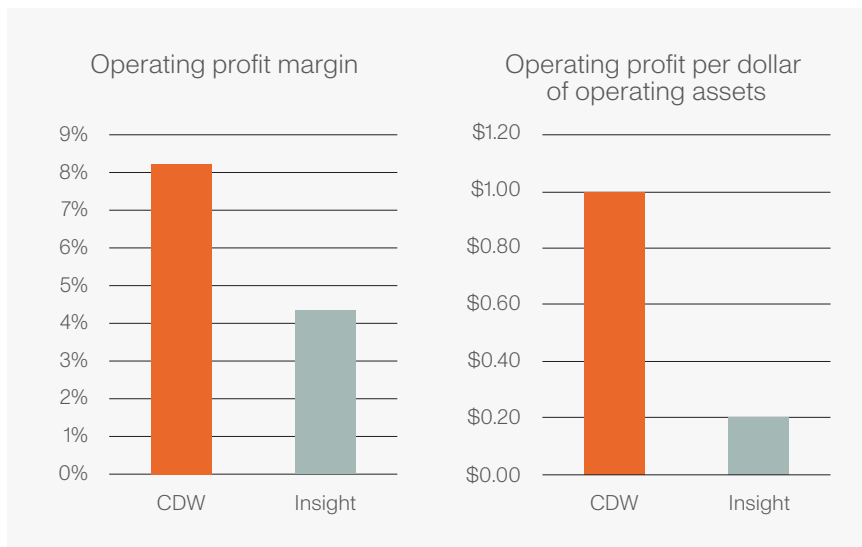
CDW is the largest IT reseller in North America. It acts as a bridge between thousands of IT vendors like Microsoft, and hundreds of thousands of small-to-mid-sized businesses, large enterprises, schools, hospitals, and government agencies. CDW helps IT vendors sell to a fragmented base of customers that they may not have the resources to reach directly. It helps organisations choose, configure, purchase and manage the right IT products for their needs.

CDW is by far the largest in its industry. Its revenue is larger than its next four competitors combined, and more than double that of the #2 reseller Insight. Its size and scale have been powerful competitive advantages on both the customer and supplier sides of the business.

CDW's size allows its salesforce to specialise by customer group, so they can provide industry-relevant advice. For instance government agencies have stringent security requirements, while schools may be more focused on the ruggedness of the devices given to their students. The company has also made acquisitions to build product expertise in areas like cloud computing and cybersecurity, so it can remain relevant and address a greater range of customer problems.

On the supplier side, CDW is usually the largest or second-largest reseller for its vendors. This means it can negotiate better pricing for customers than its peers. And if a product is in short supply, as was the case during the pandemic, CDW will be near the front of the queue and in a better position to serve its customers.

Finally, CDW's size and scale allows it to earn superior economics to its peers. It earns an operating profit margin double that of Insight. For every dollar CDW invests into its operating assets – which includes its inventory of IT hardware and warehouse infrastructure – it earns 5x as much profit than does Insight.



Due to these advantages CDW has consistently outgrown the US IT industry by 2–3% p.a., while producing returns on capital of over 20%. We expect the business to continue outgrowing its peers and earning superior economics for many years to come.

## Get in touch

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Level 2, Lawson Place  
167 Phillip Street, Sydney  
NSW, Australia  
+61 2 8098 1504  
info@auris.com.au  
[www.auris.com.au](http://www.auris.com.au)

# AORIS

**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 [auris.com.au](http://auris.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.