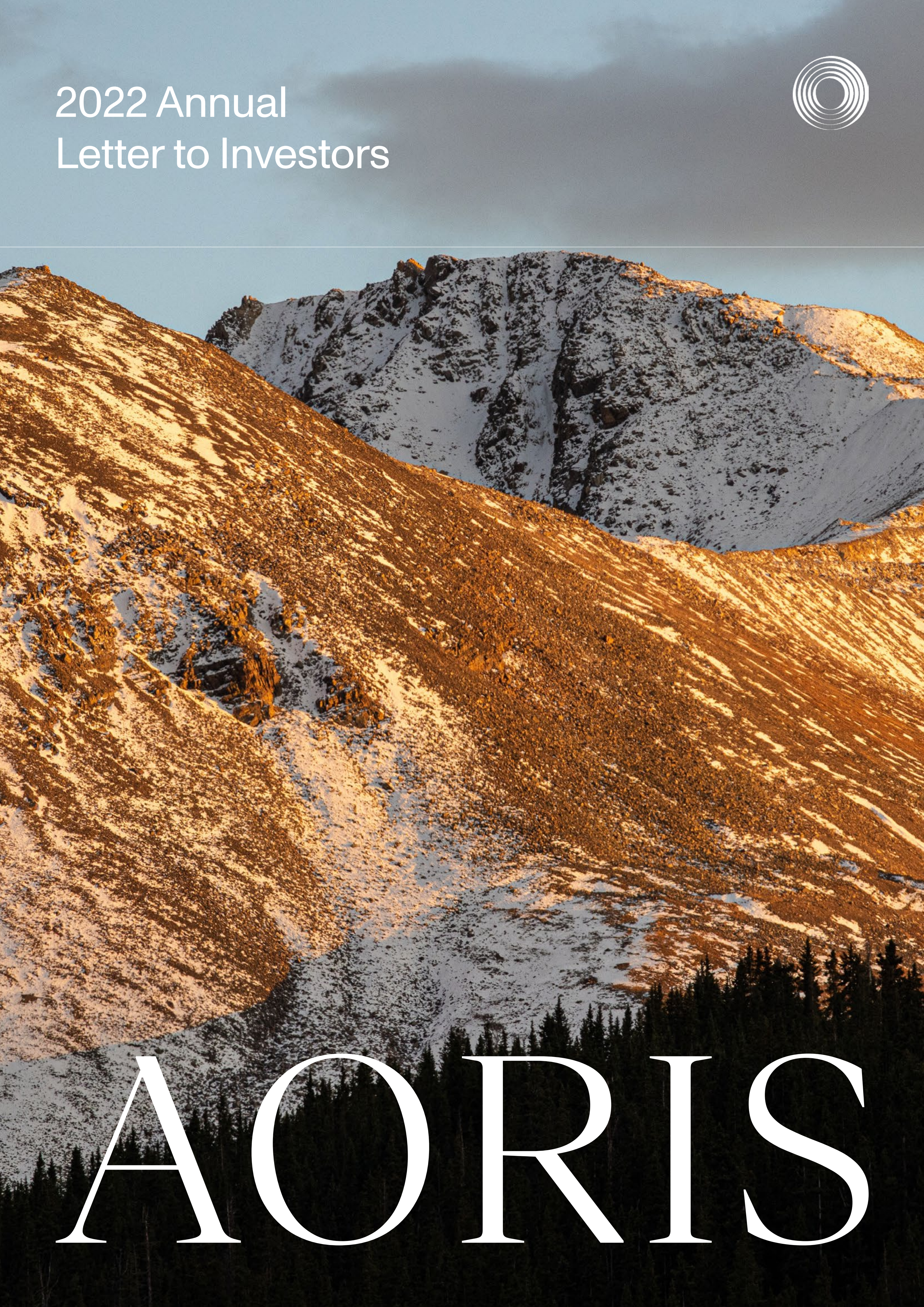
2022 Annual Letter to Investors



AORIS

Dear fellow investor,

The investment performance after fees in 2022 for our Class A (Unhedged) fund (the Fund) was −12.2%, which compares to −12.7% for its benchmark. Our Class C (Hedged) fund returned −18.0%, matching the decline of its benchmark.

Performance

Class A (Unhedged)	Aoris[1]	Benchmark	Difference
2022	−12.2%	−12.7%	0.6%
2021	41.3%	26.0%	15.3%
2020	0.4%	6.0%	−5.6%
2019	36.5%	26.9%	9.6%
2018 – nine months to December	3.2%	0.1%	3.1%
Since inception – annualised	**12.5%**	**8.6%**	**4.0%**

[1] Class A, inception 28 March 2018.

When evaluating our performance, as well as measuring ourselves against our benchmark, it's also appropriate to compare our results to those of our peers. For 2022, the Fund (Class A) ranked in the top 44% of a broad universe of international equity funds, as defined by Morningstar.

While 2022 is the subject of this letter, our focus is always on the longer term outcomes, meaning our since-inception returns. The significance of our performance record, when measured from the Fund's inception, grows with each passing year – in statistical parlance, the signal-to-noise ratio rises with time. Pleasingly, our performance since inception exceeds both our 8–12% p.a. objective and that of our benchmark, and ranks us in the top 2% of peer funds.

I believe our outperformance relative to our benchmark and most of our peers in 2022 can be attributed primarily to three factors embedded in our investment process:

1) our attraction to companies that exhibit competitive mean aversion,
2) our insistence on conservative balance sheets, and
3) our valuation discipline.

Why we own businesses that exhibit competitive mean aversion

In our 2021 Annual Letter I wrote about mean aversion, observing that the best businesses, rather than regressing to average, have a long history of gaining market share and outgrowing their peers; anti-gravity, if you will. I noted that during challenging conditions, such as 2021, the very best businesses pulled away from their peers at a faster than normal rate. When the going got tough in 2021, the tough – the exceptional businesses – really got going.

An analogy I find powerful is that of road cycling. When a group of cyclists on their morning ride are pedalling downhill, everyone is going fast, and the best cyclists are just a bit faster than the pack. But when going uphill, the stronger riders pull ahead and the difference in speed between the best and the rest is stark. In 2021, most businesses found themselves riding uphill. In 2022, the hill got steeper.

In 2022, as conditions became incrementally more challenging, we observed that the best businesses continued to outperform, both in revenue growth and profitability. In some cases, they meaningfully outperformed not only their peer average, but even their closest rivals. For example, Louis Vuitton, part of luxury goods company LVMH, grew sales in the first nine months of 2022 by more than 20%, far outpacing growth of 8% over the same period for its largest peer Gucci (owned by Kering). Similarly, over the first nine months of the year L'Oréal's sales grew by 12% compared to 7% for Estée Lauder. For its year ended August, Nike grew revenue by 7% versus zero for Adidas (year ended September), and Accenture grew revenue in the year to August by 21%, far ahead of Cognizant and CapGemini, up 10% and 15% respectively in their September year ends.

In difficult conditions, the best businesses increase their market share and improve their relative competitive position, thereby enhancing their long-term earnings power and intrinsic value. Appreciating this allowed us to face 2022 with a more constructive mindset than most investors. In 2022, as in 2021, owning only leading businesses helped our performance.

Conservative balance sheets proved valuable

For a roughly 15-year period, from the onset of the GFC in 2008 to the re-emergence of inflation in 2022, we have lived in a period of ultra-low interest rates. At some point we went through the looking glass into a strange world of negative interest rates for much of Europe's government debt, and even some corporate borrowers. This created the impression that debt is almost free, even to risky borrowers, and would be forever. The more of it, the better! Companies could take on large amounts of debt to make acquisitions or repurchase shares, increasing their per-share earnings, with no consequence to their financial risk in the eyes of the equity market.

We choose to own only companies with conservative capital structures. Every business will encounter bumps in the road from time to time, whether due to the economic cycle, competitive pressures or internal missteps. Debt, or financial leverage, is like the speed with which you hit the bump. At 20 km/hr your car will be fine, at 80 km/hr your car will get rattled but be okay, while at 140 km/hr you'll cause it permanent damage.

The rise in interest rates in 2022 was a reminder of the value of conservative financing. The ratio of debt relative to earnings before interest, tax and depreciation (EBITDA) averages just 0.4x for our portfolio. Of all non-financial companies globally, 18% have a ratio of debt to EBITDA of greater than 4x. This group of companies underperformed the broader market in 2022 by 14%.

Our valuation discipline mattered

Our disciplined approach to the prices we pay for high-quality companies also contributed to our investment success in 2022. From early 2020, when central banks sharply lowered interest rates in response to the onset of the pandemic, we went through a period when richly valued businesses markedly outperformed. As interest rates rose over 2022, that party ended and the importance of valuation reasserted itself. This benefited the Aoris portfolio, as we avoided the severe share price falls experienced by companies that a year ago were trading on what we'd term heroic price-to-earnings (P/E) multiples.

Companies whose P/E multiples exceeded 50x at the beginning of 2022, which accounts for about 20% of the broad universe of international companies, underperformed the market average in 2022 by 22%.

There were also valuation risks hiding beneath the surface in businesses trading on seemingly low multiples of earnings, but where the earnings themselves were bloated. Many companies that had enjoyed two years of extremely strong earnings growth, such as those in consumer electronics, housing and COVID-19-related health care, found the tailwinds of 2020 and 2021 abated last year, leaving an earnings air pocket. Once the COVID-19 bump to earnings disappeared, prices relative to earnings were much higher than they had appeared.

When a company's sales and profits are rising at an anomalous rate, as they were for so many businesses in 2020 and 2021 due to various COVID-19 tailwinds, management, being human, are reluctant to share the credit and attribute these exceptional results to exceptional conditions. They would have you believe, as they themselves no doubt believe, that it's all down to their talent and hard work. Rather than view their enhanced earnings as permanent, we took a sceptical view of businesses where profitability had risen rapidly, preferring to watch from the sidelines to see if the forces of mean reversion exerted themselves.

Companies whose earnings had increased by 100% or more over the prior two years accounted for 27% of all global companies at the beginning of 2022. This group underperformed the market average last year by 8%.

During a year such as 2022, it can feel like the only thing that matters to an investor is the macro-economic environment. Stories of multi-decade-high inflation, tightening central bank monetary policy, supply chain challenges, geopolitical tensions, record energy prices and so on dominated the financial news throughout the year. However, the economy does not matter to equity investing nearly as much as the daily headlines would have you believe. While they create news, the ups and downs of these economic variables are not, in fact, what creates wealth and long-term investment success.

The economy does matter, though, when it comes to those individual businesses whose earnings move in a pronounced way with the broader economy, or with the housing market, commodity prices, consumer spending or interest rates. For those businesses, the problem for the investor is it's always difficult to judge where the company is in its earnings cycle at any point in time. As such, it's easy to make an investment error through under or overestimating their 'normal' level of earnings and therefore misappraising their valuation.

Businesses whose sensitivity to macro conditions is such that their earnings turn negative during periods of economic stress present investors with an additional risk. The underlying value of these companies may regress in such times due to management error. These unforced errors can happen when management chooses to cut headcount, investment or customer service levels to protect near-term earnings, but in a way that damages the company's long-term competitive position and earnings potential.

We seek to own growing, highly profitable, competitively winning businesses where the external environment plays at most a small role, and where the difference in earnings between a good year and a not-so-good one is modest. Take Halma, for example, which is a global speciality industrial business held in the Aoris portfolio. Halma has raised its dividend by 5% or more for 43 consecutive years, a remarkable record of growth through all manner of external conditions. Or Accenture, the world's largest IT outsourcing and consulting company. In 2009, during a period of acute financial and economic stress, Accenture's earnings per share declined by just 7.5%.

For the 3000 largest companies globally, the median worst annual decline in earnings per share over the last 15 years was 78%. For the 15 companies in the Aoris portfolio, the median decline in their worst year was just 25%. For the same universe of top 3000 companies, 25% have reported a loss in at least two of the last 15 years. Those businesses underperformed the market average in 2022 by 10%. Not one company in the Aoris portfolio has lost money in any of the last 15 years.

Our approach allows us to be 'macro agnostic'; aware of the economic challenges we all read about, yet confident in the resilience and long-term growth prospects of each company in the portfolio. In 2022, as the list of macro worries grew longer, this proved particularly valuable.

Our portfolio in 2022

Of the 11 stocks we held for the entire year, six outperformed our benchmark. Our best (Cintas) rose by 10.3% in AUD while the worst (Accenture) declined by 29.9%. We often talk about our primary objective being to stay out of the worst quintile of the market as measured by share price performance. Pleasingly, not one of the 18 companies we owned during the year returned a performance that placed them in the bottom 20% of the market for the period in which we owned them.

Accenture has been one of the top contributors to the Fund's returns since inception, and its share price underperformance during 2022 stands in contrast to its strong operating performance. In its financial year ending August 2022 the company grew its revenue organically by 21%, more than double the rate of its end market, and at slightly higher profit margins than in 2021. Its customers are relying on Accenture's advice to help them navigate the growing laundry list of challenges presented by technological change, inflation, supply chains and labour shortages. You can read a more detailed profile of the business in our accompanying *December 2022 Quarterly Report*.

Nike was the one company in our portfolio that fell short of our expectations in 2022 in terms of its operational and profit performance, which was also reflected in its shares underperforming during the year. Nike's earnings have been negatively impacted over the last year by a combination of elevated ocean freight costs, excess inventory in the US that requires discounting to clear, and suppressed demand in China due to lockdowns. We don't view these factors to be permanent. As such, we believe Nike's earnings will recover over the coming year or two and we've maintained our investment in the business.

The year 2022 for Aoris as a business

For Aoris, 2022 was another year of good growth and progress. The value of funds we manage for clients increased from $604m to $719m. I wish to thank everyone who became a client of Aoris for the first time in 2022, as well as those who've been invested with us for longer.

Early in 2023, we will make our unit trust available to invest in via the ASX. Our philosophy has always been to make our single strategy widely available and easy to invest in. For many financial advice firms, as well as individual investors, purchasing units in a managed fund via the ASX is much easier than doing so via a platform or a PDS.

We significantly increased the depth of material we publish on how we apply environmental, social and governance (ESG) considerations to our investing. These are all important dimensions to how we evaluate business quality, risk and longevity. I encourage those interested to visit the ESG section of our website, where you will find our first annual *Responsible Investing and Active Ownership Report*, as well as how we voted at company AGMs over the year to June 2022.

Labour standards are an important element of ESG, and in a world of outsourcing and offshoring, cheap labour may come at the cost of someone's safety, freedom or dignity. In addition to working to minimise the risk of poor labour standards in the businesses we invest in, we've done the same with our own business. We've asked all firms who supply services to Aoris or the funds we manage, to complete a questionnaire regarding their labour policies and practices, adherence to local regulations and audits on their work sites. While this is not a comprehensive solution to eradicating poor and abusive labour practices, it's a small step in the right direction.

After a two-year absence due to pandemic restrictions, in 2022 we were once again able to spend a day in the community helping people in need, preparing and serving meals for local people with Canice's Kitchen in Sydney's Kings Cross.

Lastly, you may have noticed a new Aoris logo and brand design. As we approach our five-year anniversary as a firm, it felt like the right time to update how we present ourselves to the outside world, on our website, and in our monthly reports, *Owner's Manual*, and documents such as the one you're reading. If you take a few minutes to visit our new site, I hope you'll find it reflects our principles of transparency and simplicity, and that it's easy to find whatever information you're after. I personally welcome any feedback you may have.

The year ahead

As I look at our portfolio today, the majority of businesses we own meaningfully improved their competitive position, earnings power and intrinsic value in 2022. They enter 2023 from a position of strength. The last few years have demonstrated that challenging conditions often act as a separator, amplifying the differences between the best businesses and the rest. Should 2023 prove to be another testing year, we expect the companies in our portfolio to further widen the gap with their peers.

So, we begin 2023 as we begin every year, feeling both cautious and confident. I am cautious, aware that the economic clouds have darkened and most businesses find themselves pedalling uphill. I am confident that through owning a concentrated portfolio of exceptional businesses, which we expect to become progressively more valuable over time and where the risk of disappointment is low, we will achieve after-fee returns of 8–12% p.a. over a market cycle.

I wish you and your loved ones the very best for 2023.

Sincerely,

Stephen

Stephen Arnold
Chief Investment Officer

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