AORIS INVESTMENT MANAGEMENT

June 2018 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% pa over a market cycle.

Our Quarterly Reports

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

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

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

AORIS INVESTMENT MANAGEMENT

Aoris International Fund

Performance to 30 June 2018 - Class A	June Quarter	Since Inception*
Portfolio Return (AUD) - Net of all fees	**5%**	**5%**
MSCI AC World Accum Index (AUD)	4.3%	4.8%
Excess Return	0.7%	0.2%

*Inception date: 26 March 2018, not annualised.

MARKET AND PORTFOLIO PERFORMANCE

The Fund returned 5.0% for the quarter, outperforming our benchmark by 0.7%.

The Fund's good performance was driven by 20% increases in both Experian and CDW.

The international equity market, as measured by the MSCI AC World Index ex-Australia, appreciated by 4.3% over the three months (all returns are in AUD unless stated otherwise). Of this, 1.7% is attributable to the lower AUD against other currencies and 2.6% from local currency appreciation of overseas equity markets. Developed markets returned 5.5%, with the US and UK up by about 7% each while Europe and Japan were up about 1%. Emerging markets declined by 4.5% in the quarter. Brazil and Turkey both lost approximately 23% through a combination of market declines and currency depreciation, while China's A shares index fell 12%.

Looking at returns by sector, Energy was up 15%, reflecting the sharp appreciation in oil prices, and IT was up 8%. Financials and telecoms were both slightly down.

The Aoris International Fund (Class A) returned 5.0% for the quarter, 0.7% ahead of our benchmark. Interestingly, Industrials, the sector that MSCI classifies nine of our 14 companies as, was up just 1%, which speaks as much to how poorly the MSCI classifications represent the actual nature of a business as to the quality of our stock selection.

Key positive contributors

The two strongest contributors to performance in the quarter were Experian and CDW Group, each up approximately 20% in AUD.

Experian is the world's largest credit bureau, holding an extraordinarily rich set of payment data on hundreads of millions of individuals and businesses across 18 countries. It is a business with unusually high barriers to entry, which supports high profit margins for the incumbents. Data security is paramount and Experian has benefitted over the last year from a major

Stephen Arnold
Founder & CIO

CDW and Accenture are both IT service companies. While quite different businesses, both are significantly outgrowing the overall IT market.

data breach at Equifax, its largest competitor. We have been impressed by the emphasis Experian management has placed over the last few years on innovation and investment in product development and on return on invested capital.

CDW is the largest IT reseller in the US. It acts as a bridge between all the major IT hardware and software companies, which have salesforces that cannot directly service all the tens of thousands of medium-sized businesses, and the medium-sized businesses and government departments which benefit from CDW's expertise and purchasing scale in making IT buying decisions. CDW grew revenue on an underlying basis by 8% in the March quarter, around twice the rate at which its end markets are growing, with strong growth across all segments other than K-12 education.

Also notable was **Accenture**, which appreciated by 11%. Accenture grew revenue on an underlying basis by 9% in their quarter ended May. Growth was strong across all end markets and geographic, and exceeded 10% in Germany, Italy, France, Spain and Brazil. The company signed 13 $100m+ deals in the quarter. Accenture has an admirable record of market share gains over many years which can be in large part attributed to their ability to remain relevant to their clients. In recent years this has involved investment to acquire expertise in areas such as cloud, data security, artificial intelligence, blockchain, and digital advertising.

Key negative contributors

3M, **Illinois Tool Works**, and **Atlas Copco** each declined by 7-8% in AUD in the three months to June. This reflects a mixture of concerns around the potential impact on these companies from higher tariffs, rising commodity costs and maturity of the global economic cycle. We believe that each of these companies have strong positions in differentiated markets, an ability to manage rising input costs over time through pricing and productivity measures, and breadth across many different end markets. What also appeals to us is the fact that each company earned an attractive return on invested capital during the GFC, demonstrating their resilience in times of economic stress.

Feature - Quality Investing

INTRODUCTION

Quality to us is about the business franchise, management and capital structure soundness. We set very high standards for each.

We describe ourselves as Quality-First, Value Investors. There's no single definition of a 'quality business'. For some investors, it can be a proxy for size – Fortune Magazine's annual list of Most Admired Companies all have annual revenue of more than USD10 billion. For others, it is associated with familiarity – until very recently a list of the ten highest quality Australian businesses for most Australians would have included our five largest financial institutions, our two largest mining companies, our largest telecommunications company and our two largest retailers. For others still, 'quality' denotes rapid growth – think Amazon, Apple, Facebook and A2 Milk.

In this piece we illustrate how *we* define and think about quality. We show that the standards we apply are unusually demanding. We also demonstrate that an appraisal of quality requires subjective as well as objective assessment and therefore cannot be done purely quantitatively.

FACTOR INVESTING FOR QUALITY

In an era of quantitative-driven investing, can one 'robo invest' for quality? In other words, can we tell a computer program what 'quality' means and let it select stocks for us? Such rules-based investing exists today and often goes by the name 'factor investing' or 'smart beta'. An example is the iShares MSCI World Quality Factor ETF (Quality ETF). The Quality ETF comprises 296 companies at the time of writing – removing 16 Australian companies, leaves us with 280 international businesses. Constituents are selected formulaically based on three equally weighted criteria: return on equity; earnings variability; and debt to equity. The first two are measures of business quality, the third a measure of balance sheet quality.

BUSINESS QUALITY

Let's look at the two measures of business quality used by the Quality ETF, starting with return on equity (ROE).

$$ROE = \frac{\text{Net profit}}{\text{Shareholder equity}}$$

For banks and insurance companies, ROE can be a useful measure of profitability, expressing the earnings of a business relative to the amount of capital committed by shareholders. For non-financial companies, however, it is in practice a limited and distorted measure. The problems lie mostly in the denominator, i.e. the calculation of the capital base. Firstly, shareholders' equity in an accounting sense is a 'residual', meaning it is the balancing item after assets and liabilities have been added up. For instance, if a company takes a write-off against the asset side of its balance sheet, perhaps due to an acquisition that hasn't met expectations, it reduces the value of equity by the same amount. The now smaller denominator increases future ROE but this doesn't make the business a higher quality one.

Alternatively, if the company's auditor requires a higher discount rate to be applied to its future pension obligations, the present value of pension liabilities will be decreased and the value of equity on the balance sheet increased by an equal amount. This accounting entry will increase the denominator and thereby reduce ROE, but it does not diminish the quality of the business.

Further compromising ROE as a measure of profitability is the fact that it is influenced by the amount of debt on the balance sheet. Want to boost ROE? Take on debt and reduce the amount of shareholders' equity by paying a special dividend or repurchasing shares. This transaction doesn't make the business a better one, though it does make it a riskier one.

At Aoris we look at the profitability of a business relative to its total invested capital, which is called return on invested capital (ROIC).

$$ROIC = \frac{\text{Adjusted net profit}}{\text{equity + net debt + net pension liability + accumulated goodwill amortisation/write-offs}}$$

The denominator here is quite a mouthful, but the benefit of this comprehensive measure is that it is independent of how the business is financed, includes all historic goodwill, and it adjusts the capital base for accounting write-ups and write-downs.

We also make adjustments to the numerator. We don't take reported accounting net income at face value. Nor do we take management's own adjusted ('non-GAAP') earnings at face value (why do management's adjustments almost always create a higher net income figure?). We make our own adjustments that we believe better approximate the economic returns of the business, such as smoothing 'one-off' restructuring charges over a business cycle.

In setting a minimum after-tax return on invested capital (ROIC) in our search for quality businesses, we use 8% after tax. Part of our assessment of quality is the durability of profitability over time and resilience of profitability during times of cyclical stress. As such, we look to own businesses that have earned a return on invested capital of 8% or above in each year of the last decade. Let's look at the Quality ETF on this measure of profitability. We first remove banks and insurance companies, for which ROE is a better measure of profitability than ROIC. Of the 228 non-financial companies that had a full 10-year history, 21 earned less than 8% in half of those 10 years and six had a ROIC less than 8% in every one of the last 10 years.

Companies earning an ROIC less than 8% in:

	Quality ETF	Aoris Fund
One or more year*	88 OF 228	0 OF 15
Three or more years*	45 OF 228	0 OF 15

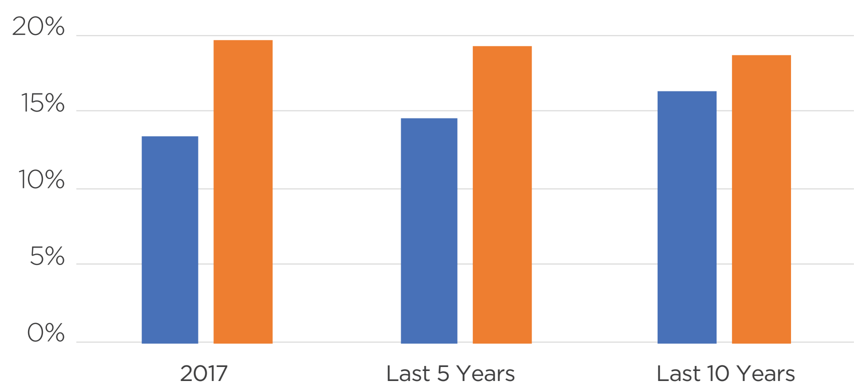
*in the last 10 years

The level of return on capital is important, but the direction is critical.

Let's now look at the profitability of banks, insurers and leveraged real estate companies – which we will collectively term 'financials'. Return on equity is a reasonable measure for this purpose, though it still has limitations such as being impacted by the amount of debt relative to equity on the balance sheet. Let's use 10% as a minimum acceptable threshold, reflecting the cyclicality, regulatory risk and debt inherent in financials. Of the 41 of these companies included in the Quality ETF that have a full 10-year operating history, 12 earned a ROE of less than 10% in three or more years; 30 of the 41 earned a ROE of less than 10% in at least one year.

So, 57 of the 269 companies in the Quality ETF with a 10-year history earned a level of profitability below what we would deem as a minimum threshold in at least three of the last 10 years.

Another way of thinking about the profitability of the businesses in a portfolio is to view the portfolio in totality. If we sum the after-tax profit and the capital base of all the non-financial companies in the Quality ETF, we can calculate an aggregate ROIC. The ROIC of the Quality ETF calculated this way was 13.4% in 2017, having averaged 14.5% over the last five years and 16.3% over the last 10. On the same measure, the ROIC for the Aoris International Fund was 19.7% in 2017, averaged 19.3% over the last five years and 18.7% over the last 10.



Source: Aoris, ishares, Factset

It is interesting to see the decline in ROIC for the Quality ETF, which compares to the slight increase in ROIC for the Aoris International Fund. A large but shrinking competitive 'moat', reflected in deteriorating profitability, is a terrible place for an investor.

Resilience in the face of economic stress matters to us as an indicator of business quality, and we won't own a business that has lost money or cut its dividends once in the last decade.

Let's now look at earnings variability, the second of the two business quality metrics used by the Quality ETF. The relevance of this metric is somewhat puzzling – you can have low variability around a low level of profitability, but that doesn't make it a high-quality business. A similar but, in our view, better indicator of quality is the absence of losses. Out of 280 companies in the Quality ETF, 60 businesses made net losses in at least one year in the last 10 and 93 cut their dividends at least once.

	Quality ETF	Aoris Fund
Made loss in at least one year*	60 OF 280	0 OF 15
Cut dividends at least once*	93 OF 280	0 OF 15

*in the last 10 years

BALANCE SHEET QUALITY

Pension obligations and operating leases are part of a company's "all-in" capital structure. We explicitly incorporate these in our assessment of quality.

How a business is financed forms an integral part of our assessment of its quality and is one of the three selection criteria for the Quality ETF. However, banks and insurance companies account for 17% of the Quality ETF by portfolio weight. Inherently, these are highly financially leveraged businesses, the consequence of which typically becomes apparent once every economic cycle. Financials do not meet our definition of a conservative capital structure, and as such do not meet our minimum threshold for a quality business. Removing these 32 businesses leaves 248 non-financial companies in the Quality ETF. The median net debt to EBITDA of this group of quality companies is 0.4x, which is indeed conservative.

However, a complete evaluation of capital structure soundness does not begin and end with the balance sheet. It requires looking at off-balance sheet liabilities, specifically defined benefit pension obligations, and operating leases. Let's take each in turn.

- **Pension obligations** – we treat the shortfall between the pension liability and the pension fund assets as being the equivalent to debt on a dollar-for-dollar basis. On top of this we add 50% of the value of the gross liability. Why? A fully-funded pension liability is not the same as no liability at all. A reduction in the discount rate used to calculate the present value of future pension payments will increase the net liability, while a decline in asset values will also increase the net liability. Thus, an apparently fully funded scheme can conceal a major economic liability. A good example of this is IBM with a gross pension liability of $106bn, which is close to fully funded but also equal to 80% of its market capitalisation.
- **Operating leases** – renting is a substitute for owning, so we capitalise the lease expense to convert to an equivalent amount of debt. We then calculate off-balance sheet leverage by summing capitalised operating leases, the net pension liability and 50% of the gross pension liability.

Companies where the ratio of off-balance sheet leverage to EBITDA:

	Quality ETF	Aoris Fund
Exceeds 2.5x	49 OF 228	0 OF 15

MANAGEMENT QUALITY

Assessing management is an essential component of evaluating the quality of an investment, but it can't be done quantitatively.

An assessment of management is an essential complement to an appraisal of a company's capital structure soundness and the strength and durability of its competitive advantages when evaluating the quality and investment merits of a business. Management is the custodian of a company's three key assets – its competitive franchise, or 'moat', its culture and values, and the capital it generates.

We are not forming a judgement of management in the singular, i.e. the CEO, but the collective – the mindset, processes, discipline and culture that inform management decisions throughout the organisation. Unfortunately, for a quantitative or rules-based approach to investing there is no ratio or score that satisfactorily measures management quality, and for this reason it isn't one of the criteria for inclusion in the Quality ETF. For a poor business, with no moat, no values and no capital there isn't much for management to protect. For a high quality, highly profitable business the contribution of management is particularly important.

We place enormous emphasis in our due diligence on an appraisal of management – including the role management performs in protecting and deepening the competitive moat, how management strengthens the company's culture and values, and its choices and mindset in capital structure and capital allocation decisions. You can't get a computer to score for this. You can certainly observe the outputs over time of poor management, hubris and neglect in the form of declining market shares, rising employee attrition and declining returns on invested capital.

VALUATION

We are looking to invest at the intersection between quality and value.

We describe ourselves as Quality First Value Investors. So, let's now take a look at the value part. Valuation is not a criterion for inclusion in the Quality ETF. As such, we would expect it to hold some stocks trading on high earnings multiples, which may undermine the ability of a portfolio of 'quality companies' to deliver quality investment outcomes. 27 of the 280 international stocks trade on multiple of prospective earnings of more than 30x. Taking out financials, which should trade on low multiples, this accounts for 11% of the non-financial group. None of the investments in the Aoris fund trade on a prospective multiple of more than 30x. It is our view that price is what makes a great business a great investment.

CONCLUSION

We believe quality is the foundation of attractive long-term investment outcomes – minimising the frequency and severity of negative outcomes and the participation in long-term wealth creation of exceptional businesses. We consider quality in three dimensions, each of which is multi-faceted:

- **Business quality** – the characteristics include strong competitive positions, breadth across end markets, durability over time, and resilience in times of stress. The manifestations of this are high cash returns on invested capital across the cycle.
- **Capital structure quality** – captures balance sheet debt, funded and unfunded pension obligations, and operating leases.
- **Management quality** – management protects and strengthens the tangible and intangible assets of the company. It is what gives us confidence that the attractive historical performance of a business will persist.

An evaluation of each of these three dimensions of quality requires judgement. Despite the power of computing and artificial intelligence, it cannot be done repeatedly well via factor investing.

Furthermore, price matters to investment outcomes. We invest only in businesses that satisfy our demanding quality criteria, and only when they can be purchased at prices less than our assessment of fair value. That is **Quality First, Value Investing.**

Portfolio Changes

L'ÓREAL

We sold LÓreal during the quarter following a period of strong share price performance. We remain admirers of the LÓreal's business, particularly its breadth across beauty categories, channels of distribution and geographical areas.

LÓreal has done a fine job in recent years taking share in the makeup category, where barriers to entry have declined and competition has increased, through both newer brands such as NYX and legacy brands like LÓreal Paris. The group was early to embrace digital communication and online distribution and has had great success with the mobile app 'Makeup Genius'.

LÓreal now sits on our 'A-list', a strong candidate for future portfolio inclusion at a lower share price.

There were no stocks added during the quarter.

Stock Profiles

CRODA

Key to Croda's success and profitability is its direct, technical engagement with customers and its high level of innovation.

Have you ever paused to wonder how makers of skin-care products are able to include on their labels such statements as 'anti-aging', 'anti-wrinkle' or 'four-hour sun protection'? The answer to that question is most likely to be Croda. Croda is the world's leading supplier of specialty ingredients for the personal-care industry. It is due to Croda's ingredients and processes that regulators allow personal-care companies, such as L'Oreal, to make these performance claims.

Croda also supplies ingredients and formulation expertise to pharmaceutical companies to help stabilise active ingredients, improve potency and extend shelf life. Croda's specialty chemicals can also be found in fertiliser, helping to improve crop yields, and in industrial applications such as engine lubricants and polymer additives, helping to improve the efficacy of the end product.

Two key foundations to Croda's success are its science and innovation and its customer intimacy.

Almost half of Croda's staff are employed in research and development, and the company also has research partnerships with many universities. Reflecting the increasing emphasis their customers place on sustainable and natural materials, a major focus of Croda's product development has been on reducing its environmental impact. In 2017, 61% of raw materials were

from renewable sources, an industry leading position. Croda has invested USD170m at a plant in Delaware, US. This new facility enables Croda to use bio-ethanol derived from natural feedstock for the manufacture of its 100% renewable surfactants, significantly reducing reliance on petrochemical ingredients in the manufacture of high-performance surfactants for the formulation of consumer products.

Croda has a direct selling model, working intimately with customers at a technical level and a culture focused on solving customer needs. It is a terrific example of what we call a 'white coat to white coat' model, where Croda's chemists and scientists are working directly with the chemists, scientists and product developers within their customer organisations. This puts Croda is a position of engaging with its users on a technical level, rather than selling to customer procurement departments.

Croda is a business with a strong competitive position in a market with immense barriers to entry. Its management is both conservative and commercial. It only wants to serve customers that value its innovation and are willing to pay a premium for it. This produces very attractive business economics – a return on invested capital of about 20% and an EBIT margin of 25%. We believe Croda will continue to grow its top line at a GDP+ rate with a very attractive profit margin, allocate capital sensibly, and grow the value of the business at a healthy rate.

AMPHENOL

Amphenol makes connectors used to join electrical circuits. It has generated extraordinary growth and high levels of profitability over many years.

Amphenol is one of the world's largest manufacturers of electronic interconnect products, also known as connectors. Connectors are relatively simple electro-mechanical devices used to join cables or to connect a wire or cable to an electrical terminal and are made for power, signal and control applications.

In a highly fragmented market with many competitors, Amphenol's long-term success stands out. Over the last 10 years it has grown its revenue on an underlying basis at around twice that of its end market, representing consistent market share gains. Amphenol's EBIT margin has averaged 20% with the lowest margin in any one year being 18%; its return on invested capital has averaged 15%; and EPS growth has averaged 13% p.a. What are the foundations of this success?

Firstly, Amphenol management pursues ‘internal diversification’ across geographical areas, end markets and applications. Markets such as mobile phone devices, commercial aerospace and automotive production all have their own demand cycles, in some cases with pronounced amplitude. By being present in many such markets, Amphenol creates diversification and a balanced business.

Secondly, Amphenol has a culture of decentralisation and accountability. Amphenol’s 100 general managers are given the responsibility to run their businesses as if they were their own but to do so within a culture and ethos where they spend company funds as if they were their own, with a strong emphasis on return on invested capital. The retention rate for senior management across the business is exceptionally high.

Lastly, Amphenol has a terrific track record for using its surplus cash to acquire small to medium-sized peers and to do so at very attractive multiples of earnings. In early 2017 Amphenol spent $60m to acquire Phitek Systems. Based in New Zealand, Phitek makes interconnect products for aircraft in-flight entertainment systems and grew revenue in the prior year by 32%. The success rate of acquisitions over a long period has been outstanding.

Amphenol’s end markets should continue to grow at attractive rates, albeit with their own cycles. The increasing array of electronics in passenger vehicles is currently driving strong growth in Amphenol’s Auto OEM business, which is about 20% of group revenue, while growth in data centres for large technology companies such as Google and Amazon has also been robust. We expect Amphenol to continue to grow profitably and add further value to shareholders through its acquisitions.

AORIS INVESTMENT MANAGEMENT

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A COMMON SENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE.

Disclaimer

This report has been prepared by Aoris Investment Management Pty Ltd ABN 11 621 586 552 (Aoris), the investment manager of Aoris International Fund (Fund). Aoris Investment Management Pty Ltd is a corporate authorized representative (CAR) of DMP Asset Management Ltd, ABN 77 145 590 316 and AFSL No 383580. 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 License No 235150). The Product Disclosure Statement (PDS) contains all of the details of the offer. Copies of the PDS are available at aorisim.com.au or can be obtained by contacting Aoris directly.

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