AIRLIE AUSTRALIAN SHARE FUND (MANAGED FUND) (ASX: AASF)

The Fund aims to provide long-term capital growth and regular income through investment in Australian equities. The fund will hold a concentrated basket of between 15-35 quality Australian listed companies – Airlie's best ideas. Maximum cash holding of 10% with an aim to be fully invested.

Matt Williams,
Portfolio manager

Emma Fisher,
Portfolio Manager

PERFORMANCE

The Australian equity market fell 6.5% in the 12 months to June 2022 and to use a well-worn sporting cliché – the year was a tale of two halves. In the six months to 31st December 2021 the index (including dividends) was up 4%. For the calendar year to December 2021 the market finished up 17% as companies took advantage of low interest rates to undertake mergers and acquisitions, boosted by a healthy consumer - spending their covid stimulus and savings, and enjoying a tight labour market. In the latter half of 2021 the threat of inflation was building but not yet manifest. However, the second half of the financial year 2022 was markedly different with the accumulation index falling 10% as inflation fears took hold and central banks declared that the party of the last ten years was over. The Russian invasion of Ukraine poured petrol on the inflationary fire. So the last six months of financial year 2022 has resulted in a reasonably rare occasion where bonds and equities both fell in value concurrently. In fact, for a typical 60/40 portfolio this was the second worst six-month performance period of all time!

Although falling 'only' 10% in the six months to June 2022 (e.g. the S&P 500 was down 21%) the Australian equity market saw some quite disparate sector performances with only two GICS sectors in positive territory with energy (+27%) and utilities (+13%). All the other nine sectors were down with the worst being the former champion for a number of years - information technology (-37%), followed by property (-25%), and consumer discretionary (-24%).

The Airlie Australian Share Fund returned -7.4% over FY2022, underperforming the benchmark by -0.9%. This is a disappointing result and a direct outcome of being underweight energy and overweight consumer discretionary. As investors would be aware, we build the portfolio on a stock-by-stock basis and not by trying to predict major macro moves i.e. the direction of the oil price. Nevertheless, the best contributing company in the portfolio over the year was our major energy exposure – Ampol (+21%), which benefitted from the expansion of oil refining margins in the wake of the Ukrainian situation and global under-investment in refining capacity. This was a remarkable turnaround from last year when the Federal government stepped in to provide support to refiners to prevent their closure. Ampol also completed the Z Energy acquisition during the quarter, which we believe should be double-digit EPS accretive. The other top contributors to the fund were EBOS (+16% - pharmacy wholesale/distribution, pet food) , SCA Property (+14% - supermarket landlord), and Tabcorp (+9% - wagering and lotteries); overall an eclectic mix of contributors with no common theme.

Conversely the detractors to performance can be grouped by the major themes that took hold during 2022:

- Consumer discretionary came under pressure as rising interest rates lifted mortgage repayments and reducing disposable income: Wesfarmers (-27% - Bunnings, Kmart), and ARB (-35% - 4WD accessories)
- Companies heavily exposed to the US were very weak as commentators predict certain recession: James Hardie (-25% - building materials), News Corporation (-30% - media, REA), and Aristocrat (-20% - gaming content)
- Interest rate sensitive companies were weak as rates rise rapidly: Charter Hall (-30% - property fund manager)

Despite the performance of the share prices of some of our portfolio holdings over the last 12 months, particularly those at the pointy end of recession fears, we still really like their prospects. We believe our major consumer discretionary exposures each have a unique offering with great prospects and rock solid balance sheets e.g. Wesfarmers with the incredibly strong Bunnings dominant franchise; ARB with global growth prospects (e.g. Ford Bronco contract), Premier Investments (Smiggle, Peter Alexander) also with global growth prospects; and Nick Scali (furniture) with strong domestic store roll-out opportunities. Being underweight the Energy sector is not unusual for Airlie. Generally, oil and gas companies struggle to get past our Business Quality test – being high capex, low returning and hence generally poor dividend payers. Over 10 years for example the underperformance of Energy versus the overall market is stark as shown by the chart below. Occasionally geopolitical events conspire to cause sharp moves in the energy complex, as we are experiencing now. We consider all opportunities and the possibilities of longer-term structural changes in any industry.

Source: Iress

However, it's not just companies that are owned in the portfolio that affect relative performance. Companies that we consider in our 'wheelhouse' that we 'missed' include Computershare (+49% - business services), Endeavour Group (+17% - hospitality), IGO (+30% - Lithium, nickel), and Ramsay (+16% - private hospitals). Good avoids include companies on our quality radar including REA (-33% - digital advertising), Xero (-44% - accounting software), JB Hi-Fi (-20% - consumer electronics), and OZ Minerals (-20% - copper).

OUTLOOK

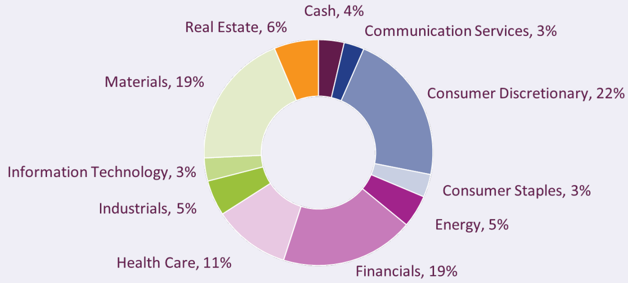
The outlook for equities is incredibly unclear. We have talked prior that markets are at the crossroads after a +10-year bull market - inflation and interest rates are on the rise and so central banks are reversing course after a decade plus of super easy policies. The early result of this, and exacerbated by the Ukraine invasion, is a return of market volatility. After being super strong in the March quarter, even commodity prices are now weakening, putting further pressure on the Aussie market. As fabled investor Peter Lynch says – "If you can only follow one piece of data - follow the earnings…". Given profit margins overall are at record highs; stimulus is unwinding; costs pressures abound; and consumers will likely have less disposable income – then an easy bear case for the direction of earnings can be outlined. Consensus earnings one to two years out are probably too high. However, this bearish view must be balanced against valuations that have been very quick to price in higher rates, and company balance sheets that remain strong (although we need to monitor this vigilantly). For consumers, the most recent (two to three years) cohort of mortgage borrowers may provide some bad debt and hence headline angst but generally consumer balance sheets are in reasonable shape. High levels of personal and mortgage debts is balanced by high savings, solid home equity, and current strong employment conditions.

PORTFOLIO POSITIONING

Top-10 holdings at 30 June 2022

Security	Weight (%)
BHP Group Ltd	10.2%
CSL Ltd	7.9%
Commonwealth Bank of Australia	7.2%
Mineral Resources Ltd	5.1%
National Australia Bank Ltd	4.6%
Macquarie Group Ltd	4.4%
Wesfarmers Ltd	4.3%
Aristocrat Leisure Ltd	3.8%
PWR Holdings Ltd	3.4%
Woolworths Limited	3.3%
Total	54.2%

Sector exposure[1]



As bottom-up stock-pickers, we invest on company fundamentals: seeking conservative balance sheets, businesses that generate good returns and are managed by competent people. However, from a top-down perspective we want to avoid "unintended bets"; i.e., positioning the portfolio in a way that leaves it vulnerable to certain macro events playing out. The key macro event to watch this year is inflation. There is no doubt in the near term that inflation will continue to increase: most of the companies we speak to are seeing significant input cost (and increasingly labour) inflation, and have signalled their intent to pass this on in the form of higher prices. Since we think inflation is heading up in the near-term, it's important to make sure our portfolio owns businesses with pricing power, that can protect margins and pass on higher costs to end consumers. We have analysed our portfolio through this lens and think we are well positioned. Businesses like James Hardie, Woolworths, Wesfarmers, Macquarie, the banks, Aristocrat and CSL should all benefit from (or at least not suffer from) higher inflation.

The market has been quick to reprice those businesses whose valuations had benefited from the "lower-for-longer" interest rate tailwind of the last decade, chiefly high PE structural growth stories, loss-making tech companies and REITs. We believe there are additional nuances to consider. We are avoiding businesses with high ongoing capex needs, as inflation makes it more expensive to stand still, and businesses with material exposure to floating-rate debt. Meanwhile, we spend our time sifting through the wreckage of heavily sold-off companies for opportunities where good businesses have been mispriced

With respect to stock selection for the portfolio, we weigh four factors when considering an investment:

Financial strength: We want to own businesses with conservative levels of gearing and strong cash flows. While corporate balance sheets are in great shape across the board, with average net debt to EBITDA for ASX200 companies of 1.8x (well below the 10-year median of 2.5x), our portfolio has an average net debt to EBITDA of 0.3x. Further, 38% of our portfolio companies are in fact net cash. We believe this sets us up for strong future returns, whether through dividends, special dividends, buybacks, investment or acquisitions.

Business quality: We focus on businesses that can generate good or improving returns on their invested capital (ROIC). The reason is simple: higher returning businesses require less reinvestment to grow earnings, so more cash is available for shareholders. We believe a business can only sustain a high ROIC over the medium term if it has something special: barriers to entry, pricing power, favourable industry structure and/or a strong product that resonates with customers. When you invest in the ASX200 index, the median pre-tax ROIC is 14% (this excludes financials and REITs). By contrast, the pre-tax ROIC of our portfolio (ex financials and REITs) is 20%. This reflects our process, which selects for high (or improving) ROIC companies.

Management quality: We look for alignment with shareholders, whether that be through significant management shareholdings, or appropriate long-term incentives. The ultimate model of alignment for us is owner-managed businesses, where the original founder remains in control. We believe these businesses tend to outperform over the long term, and owner-managed businesses comprise c30% of our portfolio, compared to 10% of the ASX200.

Valuation: We believe the returns a business generates drive the value of the business, and seek to invest where the above factors are underappreciated in the prevailing market share price.

Matt Williams **Emma Fisher**

Performance as at 30 June 2022 [2]

	1 year (%)	3 years (% p.a.)	Since inception (% p.a.)
Airlie Australian Share Fund (Managed Fund) (ASX: AASF)	**-7.4**	**8.0**	**7.8**
Banchmark (S&P/ASX 200 Accum. Index)	**-6.5**	**3.3**	**6.1**
Excess	**-0.9**	**4.7**	**1.7**

1 Based on GICS Sector classification, may not sum to 100% due to rounding.

2 Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD. Fund inception date:1 June 2018.

IMPORTANT INFORMATION