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8 May 2020

ASX Market Announcements
ASX Limited
Exchange Centre
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BY ELECTRONIC LODGEMENT

Investor Letter from VGI Partners Limited

VGI Partners Global Investments Limited (ASX:VG1) is pleased to make available the enclosed investor letter. The letter was prepared by VGI Partners Limited (the Manager) in relation to the performance of VG1 for the first four months of calendar 2020.

Ian Cameron
Company Secretary

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VGI PARTNERS

8th May 2020

Investor Letter

Dear Fellow Investors,

It is our custom to write to you twice each year, in January and July, to discuss the performance of the **VGI Partners Global Investments Limited (ASX:VG1)** portfolio and some of our current thinking. However, these are unusual circumstances as we are in the midst of a period of exceptional volatility in global equity markets; major stock market indices fell by more than 30% in February and March before retracing a substantial part of this decline by the end of April. We thought this interim letter would provide an opportunity to describe how we have been applying the VGI Partners investment philosophy in a turbulent environment.

While we discuss some of our recent mistakes, we believe we are well positioned to deliver on our investment objectives over the long-term. Most importantly, VG1 is invested in a portfolio of high-quality companies that we expect will come out of this public health and economic crisis even stronger.

Although this letter addresses market conditions and portfolio performance over the course of only a few months, it is important to stress that at VGI Partners we do not invest for the short-term. However, in order to illustrate how the portfolio has performed and the consequences of our decisions in a fast-changing environment, this letter will discuss recent monthly returns. VG1's strong outperformance during a falling market in March was followed by underperformance against a rising market in April. This deserves an explanation.

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For the four months to the end of April, the VG1 portfolio recorded a roughly breakeven return of **+0.1%**.

Looking back, we went into this period of heightened market volatility and economic uncertainty with a portfolio of some of the best businesses in the world. When the market outlook started to deteriorate meaningfully in early March, we maintained our usual focus on capital preservation as we assessed how best to position the VG1 portfolio for the quickly changing environment.

Our general practice is to make only relatively minor adjustments to our portfolio of high-quality, long-term Long Investments, unless they have become unjustifiably expensive or the facts have changed. We don't like to sell our holdings in great businesses, which we have generally purchased at much lower prices, as there may never be a chance to buy back in at a better price. We also avoid unnecessarily crystalising tax liabilities on our investments in companies that we know we will want to own for the long-term.

Consistent with this approach, during March we sold or reduced our holdings only in the few Long Investments that we didn't believe would perform as well as others in this new world and resultant economic outlook. Nonetheless we acted too slowly. We also added to a number of Long Investments at attractive prices, and initiated one new position.

The primary way that we protect the portfolio and seek to preserve capital is by increasing our Short Positions (which make money for the portfolio if share prices fall), thereby lowering our net exposure. This was central to our approach in March, as we added to our Short Positions early in the month. We closed some of these positions at a significant profit after markets fell, but in hindsight it was a mistake not to have closed more. During the month of March, VG1 recorded a positive return of **+1.4%**, which compares with the negative return of **-7.7%** recorded by the MSCI World Total Return Index (AUD).

At the start of April, the VG1 portfolio was positioned for the broad-based consumer crisis that we thought would inevitably follow what had effectively become a global economic shutdown. Our net market exposure was down to 45%, as our high-quality Long exposure (85%) was offset by increased Short Positions (40%). This means that on average for every $100,000 you had invested with VGI Partners at the start of April, we owned $85,000 of equities and sold short $40,000 of equities, for a net equity exposure of $45,000.

The Short Positions were concentrated towards companies that we expected to be particularly hard-hit in a period of economic recession in which consumers spend more time at home, cut back on discretionary spending and travel, and avoid public spaces. This was the lowest net market exposure that we have had in the VGI Partners global strategy since the financial crisis in 2008/2009, and at the time we believed it to be appropriate for the conditions.

We did not anticipate that April 2020 would mark the best monthly gains for many market indices since 1987. During the month, markets increasingly priced in a rapid rebound in economic activity – what some may refer to as a “V-shaped recovery”. Markets have stuck firmly to their view that, for most companies, profits will be higher in 2022 than they were in 2019. We strongly disagree.

Our cautiously-positioned VG1 portfolio did not perform well in this environment during April. A number of our Short Positions increased by more than the broader market as investors quickly priced in a reopening of economies and a return to “business as usual” for consumers. The Australian Dollar also performed strongly for the month as confidence returned to markets more broadly. This created a further headwind given that the portfolio is predominantly exposed to the US Dollar, despite having reduced some of our US Dollar exposure as the Australian Dollar moved to the 57-58 cent range in March.

As a result, VG1 recorded a **-4.5%** net return for April which consisted of a **+4.7%** positive return from Long Investments, a **-4.9%** detraction from Short Positions and a **-4.3%** detraction resulting from our long-term strategic currency positioning.

We are deeply disappointed to now be writing to you following a month where our performance has fallen well short of the broader market. However, while we always strive to preserve capital this does not mean that we won’t have periods of relative underperformance, or even negative performance.

VG1’s April performance was generated in an environment where the equity market, buoyed by central bank intervention, was seemingly looking through a dire economic reality that we are not prepared to ignore. The seriousness of the economic situation is not a secret. Kevin Hassett, who recently returned to the White House to advise President Trump on economic policy, recently commented that he expects to see an unemployment rate in the United States of around 19% when the jobs report comes out later this week. A similar scenario is playing out across many major economies, including Australia.

While short-term income replacement initiatives mean that the unemployed receive more support today than previously, we do not believe the global economy can rebound quickly from a rapid increase in unemployment, reduced household incomes and changed consumer behaviour. Just think for a moment about how quickly you expect to return to your previous way of life when it comes to dining out, shopping and travelling. We doubt that a so-called V-shaped recovery will eventuate.

However, it would be misleading to attribute VG1's underperformance in April simply to a difference in opinion in relation to the economic outlook. We have unfortunately made a number of costly unforced errors; firstly, just as we should have been quicker to cut some of our Long Investments where the facts had changed, we should have increased our Short exposure a little earlier than we did in March. Then, once we had repositioned the portfolio to reflect our concerns over the impact on company profits of substantially reduced household incomes, we should have been quicker to recognize that the announcement of unprecedented stimulus and wage-replacement programs around the world would defer the negative consequences for a number of companies in which we had initiated Short Positions.

While we will learn our lessons from all these mistakes, as noted earlier in this letter we believe we are well-positioned to deliver on our investment objectives over the long-term.

The high-quality companies in the VG1 portfolio are set to benefit from an acceleration of themes that we have been observing for some time. To give just two examples, housebound consumers are increasingly favouring online retail over bricks and mortar, while a fear of infection means that even those transactions taking place in physical stores are increasingly migrating from cash to card. Through our holdings in Amazon and MasterCard, these two themes represent over 25% of the total investment portfolio. We believe that both of these companies are positioned well for the long-term.

Similarly, while currency was a headwind during April, we are comfortable maintaining our US Dollar exposure at current levels. As we have explained in previous letters, our strategic currency position is based on our proprietary analysis of the Australian and global economies and has generated considerable incremental returns for our portfolios over the years. You may recall that we started the year expecting that the official interest rate in Australia was likely to be cut in an effort to stimulate the economy following years in which Australia's economic statistics had been flattered by an unsustainable consumer debt binge. Australian households are now amongst the most leveraged in the western world.

It is our belief that Australia's structural challenges include a high cost of labour and limited productivity improvements over the last few years. We see labour reform as necessary to reinvigorate the system and without this we expect that the Australian Dollar will come under further pressure.

We now see more reason to be cautious regarding the outlook for Australia as a consequence of the pandemic. The Australian economy may ultimately be particularly hard-hit by the virus due to the significance of sectors such as tourism and international education. It is now clear that these sectors will be negatively impacted for a long time.

In addition, we expect that global demand for Chinese exports will decrease as the western world enters into recession. The Chinese economy is likely to experience headwinds as manufacturing supply chains come under review across the world, particularly in critical industries, with some level of onshoring of manufacturing now inevitable. In our view, this will hit Australia through reduced demand for our key exports of iron ore and coal.

While we believe it is likely that the Australian Dollar will trade materially lower over the longer term, as mentioned earlier we did buy some Australian Dollars in the 57-58 cent range in March. We were subsequently surprised by the speed of the movement to 65 cents in April. At this stage we have no intention of reducing our exposure to the US Dollar at current levels.

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In closing, we would remind you that there is strong alignment between the Manager and shareholders.

Over the past twelve years (since inception of VGI Partners), all members of the VGI Partners Investment Team have consistently added to their investments in the Funds managed by VGI Partners. The VGI Partners team and their families now have around $90 million invested alongside you in the VGI Partners Global strategy, with a further $35 million invested in the VGI Partners Asian strategy. We all view these investments as our primary capital growth vehicle and thus our most important financial investment.

As a result of the above, you should feel confident that our Investment Team's energy and effort is focussed on a singular outcome – to maximise returns while preserving capital for our collective portfolio. We will make mistakes in the future but we will admit them, learn from them and move forward.

We are very grateful that we have long-term oriented investors who entrust us with their capital. Once again, we thank you for your investment with VGI Partners and look forward to writing to you with a further update in July.

Yours faithfully,

VGI Partners

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