AORIS

Quarterly Report

March 2024

Aoris International Fund

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

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 31 March 2024

Class A (Unhedged – base fee option) Inception 26 March 2018	**March Quarter**	**1 Year**	**Since inception p.a.***
Portfolio return (AUD) net of all fees	13.5%	31.5%	17.3%
MSCI AC World Accum Index ex-Australia (AUD)	13.3%	26.7%	12.6%
Excess return	0.2%	4.8%	4.7%

Class C (Hedged – base fee option) Inception 28 September 2018	**March Quarter**	**1 Year**	**Since inception p.a.***
Portfolio return (AUD) – net of all fees	9.2%	26.2%	13.9%
MSCI AC World Accum Index ex-Australia 100% Hedged (AUD)	9.5%	23.1%	8.7%
Excess return	-0.2%	3.1%	5.2%

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

Market and portfolio performance

International equity markets, as measured by the MSCI AC World Accumulation Index ex-Australia, rose by 13.3% for the March quarter (all returns are in A$ unless stated otherwise). Equity markets rose by 9.5% in local currency terms, while changes in currency values added 4.8% to the A$ return.

As shown in the table on the previous page, the Aoris International Fund (Class A – Unhedged) returned 13.5% for the quarter, slightly exceeding the return of its benchmark. The Aoris International Fund (Class C – Hedged) returned 9.2% in the period, 0.2% behind its benchmark.

The March quarter was another gratifying one for shareholders of NVIDIA, the world's leading producer of microprocessors used for graphic processing and, increasingly, artificial intelligence (AI) computing tasks. NVIDIA's share price appreciated by over 80% in the three months to March. Since the beginning of 2023, NVIDIA's share price has risen by around 600% and its market valuation by approximately US$1.8 trillion.

We keep hearing about the wonders of AI and how nascent its adoption is. We also know that NVIDIA's chips are integral to the process and far ahead of competitors. NVIDIA would appear to have a lock on the technology revolution of our generation.

While the world watches NVIDIA's rise with admiration and envy, it's worth pausing to reflect on two other American companies whose future growth and prosperity once appeared assured.

In the early 2000s, Intel had a seemingly vice-like grip on the market for microprocessors used in personal computers and high-end servers. Intel had a market share 10x the size of its nearest competitor, AMD, and was the undisputed leader in making chips at the most advanced technical specifications. It wasn't just a case of 'Intel Inside', it was Intel Everywhere. Its scale brought with it enormous advantages in R&D investments and manufacturing capabilities.

That was the zenith for Intel. The company completely missed the growth in mobile computing, losing out to chip-design companies such as ARM and Qualcomm, while TSMC's role as contract manufacturer saw it overtake Intel in chip-manufacturing expertise. Intel's share price today is about the same as it was 20 years ago, which compares to a 450% rise for the S&P 500.

A more recent example is Tesla, which in late 2021 had a market valuation of $1.25 trillion. At the time it appeared almost certain that new passenger vehicle sales would rapidly shift from internal combustion engines (ICEs) to battery-powered electric vehicles (EVs) and that Tesla would dominate this market. Countries including the UK, Germany, Italy and China had announced bans on future sales of ICEs, as had a number of US states. Traditional auto makers were floundering in their attempts to make EVs at scale and to match Tesla's wow factor with auto buyers.

Since then, some European countries have delayed or walked back from their commitments to phase out ICEs. Many EV owners are finding the cost of insuring and repairing their vehicle to be much higher than they expected, and the experience of finding a charger in their apartment building or corporate car park to be a regular headache.

Chinese EV manufacturers such as BYD, Geely and Chery are inundating the global EV market at price points far below Tesla's. Last year, Tesla lost its crown as the world's largest EV manufacturer to BYD and it has cut prices by as much as 26% in the US, pressuring its profitability and upsetting Tesla owners whose near-new vehicle is now worth considerably less. Since Tesla's share price peaked in late 2021, it has lost around US$750 billion in value.

While the euphoria around NVIDIA and Tesla may continue, we'll be watching from the sidelines. We prefer to own businesses in growing but competitively stable markets, where leadership has been demonstrated over many years and the government plays a minor role at most. Importantly, the businesses in our portfolio have breadth, serving many end markets rather than their fortunes being dependent on a single product or market.

TRIM 2
TRIM 1
T2-19
T2-20
T2-20

Company profile

Atlas Copco

Atlas Copco's industrial equipment makes manufacturing processes more efficient.

Atlas Copco is a global provider of industrial equipment that's used to make a wide range of manufacturing processes more efficient. These include air compressors used in many industrial processes, vacuum pumps used to create a particle-free environment for semiconductor manufacturing, and power tools and machine vision used in industrial applications like automotive manufacturing. The company is based in Sweden, and last year celebrated its 150th anniversary.

Atlas Copco generally has leadership positions in profitable, high-value niches of the broad markets in which it operates. It chooses to operate only in product categories where it can provide differentiated technology, whose value proposition is clearly measurable, and where customers are willing to pay for this value. For example, energy consumption makes up about 80% of the lifetime cost of an air compressor, so a more energy-efficient model can represent considerable savings to customers.

The company supports its premium products with premium servicing, delivered by its team of 4000 highly skilled technicians. It earns over one-third of its revenue from spare parts, maintenance and repair services, and consumables and accessories used with its equipment. These services allow Atlas Copco to engage more frequently and create stronger relationships with its customers. Services have gradually become a larger proportion of Atlas Copco's revenue as they've been adopted by a growing percentage of its customers.

Atlas Copco is widely revered for its corporate culture and the quality of its business leaders. It's a self-selecting entrepreneurial environment where employees are encouraged to take accountability for their own career and learning journey. The company supports them with extensive training and development materials, and with a high degree of internal mobility – any employee can apply for any open position at any group company around the world. In return, employees are expected to be committed to the company's vision, strategy and structure.

These attributes have allowed Atlas Copco to deliver long term organic revenue growth of around 6% p.a. and a return on invested capital well above 20%, which has remained resilient even through cyclical downturns. It adds another few percent of profit growth each year from acquisitions that operate in areas close to its existing businesses, and in many cases help to strengthen them. We expect the business to continue growing profitably at a healthy rate for many years to come.

Portfolio Changes

Purchases

Compass Group

Headquartered in the UK, Compass is the world's largest contract catering business. It serves over 16 million meals a day across tens of thousands of corporate offices, hospitals, schools and universities, mining sites, and sporting and entertainment venues.

A growing share of catering sites are being outsourced to third parties like Compass, allowing its customers to focus on their core businesses. Compass has consistently outgrown its catering peers and has industry-leading rates of customer retention and satisfaction. On average it keeps its customers for 25 years.

We had previously owned Compass Group and sold it from the portfolio in March 2020. The business recovered faster from the COVID-19 pandemic than we anticipated and has emerged from the pandemic competitively stronger.

Visa

Visa is best known for enabling consumers to make debit and credit card payments. In the year to September 2023, 4.3 billion Visa cardholders made 213 billion transactions on its network, to a total value of $12.1 trillion.

Visa has consistently grown the number of cardholders on its network and the number of merchants that accept Visa payments. It benefits from the ongoing displacement of cash with cards in consumer payments. Adoption of its network is also aided by the rise of e-commerce, the development of lower friction tap-to-pay mobile payment technology, and Visa's investments in reducing fraud on its network.

We believe Visa can continue to grow revenue and earnings at around 10% p.a. for many years. We made our investment in the business at a material discount to our appraisal of fair value.

Sales

Tractor Supply

Tractor Supply is by far the leader in rural supplies retailing in the US. It's been a consistent market share gainer within its niche, and continually invests to improve its customer relevance and satisfaction. We sold Tractor Supply to fund our investment in Compass Group, which we consider to be a higher-quality business that trades at an attractive valuation.

Costco

We sold our position in Costco during the quarter, solely due to valuation. Its share price appreciated by over 50% in USD over the last 12 months and was trading at a price above our fair value for the business. We have a high degree of confidence in the durability of Costco's growth and success and hope be able to repurchase an investment in the business in the future at a more attractive valuation.

High risk, low reward?

Written by Delian Entchev,
Portfolio Manager

Introduction

One of the first concepts taught to finance students is the correlation between risk and reward. The premise is that securities are correctly priced and investors can only earn higher returns by assuming more risk. This is often referred to as a 'risk premium'.

Outperforming the market is hard, so instinctively this sounds right. But is it true in practice?

Contrary to theory, most high-risk businesses have delivered poor long-term returns.

In this feature article we show that, contrary to theory, most high-risk businesses have delivered poor long-term returns, and investors are assuming unnecessary risk in owning them.

We then discuss some of the ways our conservative investment approach helps us avoid these high-risk, low-reward businesses.

What makes a business high risk?

Investors commonly measure risk through share price volatility, which means the magnitude of a company's share price moves.

Share price volatility can certainly be a source of risk if it affects an investor's ability to make good judgements about a business. Wildly fluctuating prices can shake investors' confidence in a business and its underlying value.

However, we believe share price volatility is merely an outcome of the underlying risk characteristics of a business.

At Aoris, we exclude parts of the market where we believe the risk of a disappointing outcome is high. Some of the types of high-risk businesses we avoid are:

1. Unprofitable companies.
2. Companies with high levels of debt.
3. Companies based in emerging markets.
4. Companies with volatile earnings.

To test the relationship between risk and reward, we studied the annual Australian dollar total returns of the largest 3000 public companies globally over each of the last 20 years. We then compared the performance of these four types of high-risk businesses to all the other companies.

1. Unprofitable companies

Investors own loss-making businesses in the expectation they'll eventually become profitable, and that the price they're paying today is low relative to future profits. The risk they're taking is that if a business continues to lose money, it won't be worth anything at all.

Investors may expect a fundamentally bad business with poor economics to turn its fortunes around. That's rarely as easy as the PowerPoint slides make it seem. If a business is already unprofitable, it's limited in what it can invest to grow into profitability, and there's only so far that cost-cutting can be taken. For example, the six largest publicly listed online food delivery companies have generated a cumulative US$24 billion in losses over the last five years, and despite a surge in demand through the pandemic none of them are profitable yet.

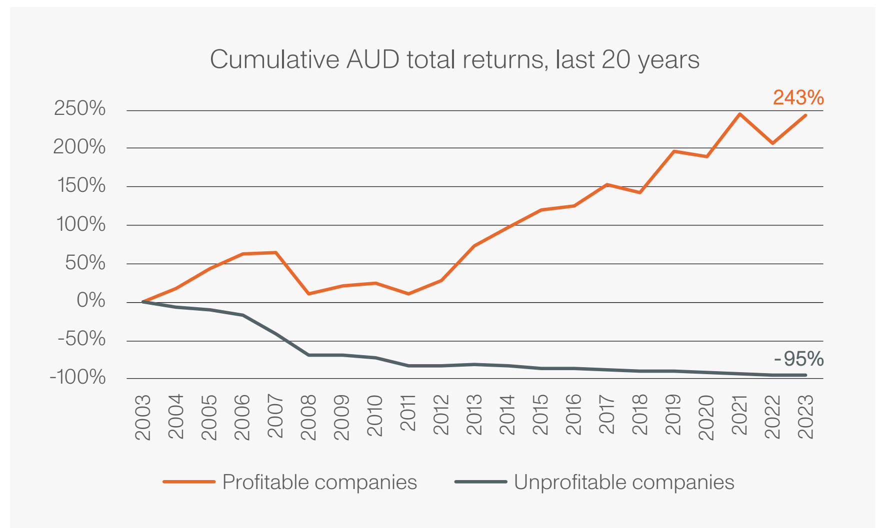
The investor may also be hoping an unproven, early stage business becomes the next big thing. The problem is that for every Tesla – which only made its first full-year profit in 2020 after 18 years of losses – there are many that never become profitable. History is littered with the likes of Nikola Motors, WeWork, and Groupon. The success stories captivate the attention of investors and the media more than the many failures.

Loss-making businesses have underperformed in every one of the last 20 years.

In either case, our study shows that unprofitable companies rarely live up to their promise.

Incredibly, in every one of the last 20 years, the cohort of loss-making companies (as measured by net profit after tax) delivered a lower investment return than the cohort of profitable ones.

The cumulative difference in returns over 20 years is stark. Investing in a portfolio of loss-making companies would have left you with just 5% of your starting capital. If you only invested in profitable businesses you would have generated a return of 243%.



Investors can earn better returns by focusing on established, market-leading businesses that have a long history of profitable growth where they don't need to make heroic assumptions about the future to justify their valuation.

2. Highly indebted companies

Debt allows companies to make investments beyond what their current level of profit can support. This is why it's also known as 'leverage' – just like a lever in physics, the additional funding from debt can magnify a company's profits.

Companies often end up with a lot of debt after making large acquisitions. For instance, many telecom companies are still burdened with high debt from an M&A frenzy during the dot-com boom. Management often presents a compelling case about the expected uplift in earnings from these transactions, and how quickly it believes the company will be able to pay down its debt.

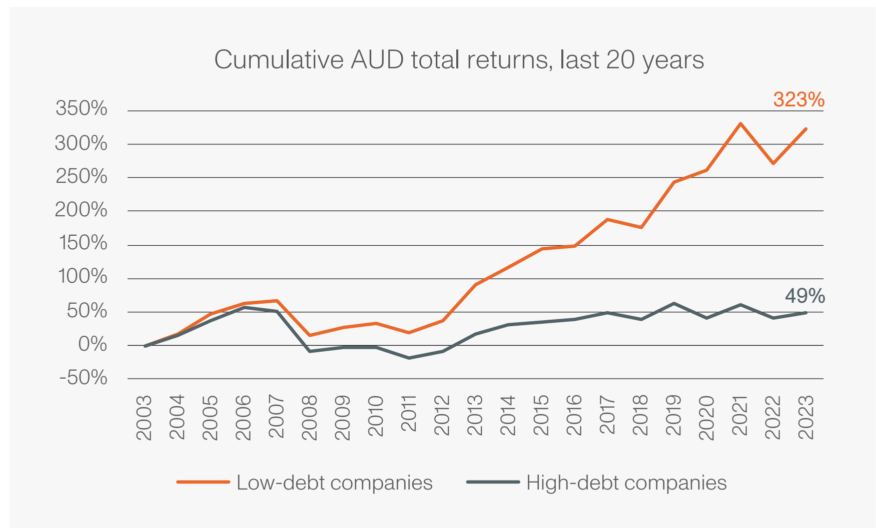
High levels of debt may seem fine when a business is experiencing favourable conditions and when interest rates are low. But leverage goes both ways. It also amplifies any natural down cycles or business problems, and it leaves companies exposed to future increases in interest rates.

If a company takes on too much debt it may be forced to cut back on essential resources to be able to meet its interest bill, which can compromise its growth prospects. A recent example is Revlon, which was limping along for decades with high debt, no growth and minimal profits, until rising interest rates finally forced it into bankruptcy in 2023.

How much debt is too much? A common measure of leverage is Net Debt – the level of debt in a business minus its cash holdings – divided by EBITDA, which are its profits before interest, tax, depreciation and amortisation expenses. For the purpose of this study we define highly indebted businesses as those with Net Debt/EBITDA of over 3x.

Over 20 years, highly indebted companies have returned just 2% p.a.

Over the last 20 years, a portfolio of highly indebted companies returned just 2% p.a. compared to 7.5% p.a. from those with better balance sheets. The highly indebted companies underperformed in 16 of the 20 years.



Investors would be better served by owning businesses with conservative balance sheets, which can not only weather any downturns but also use them as opportunities to widen the gap to their less well-positioned peers and to make strategic acquisitions.

3. Companies based in emerging markets

The very term 'emerging markets' evokes images of more rapid growth than the staid-sounding 'developed world'. Investors expect that a faster rate of economic growth in these countries will translate into superior returns.

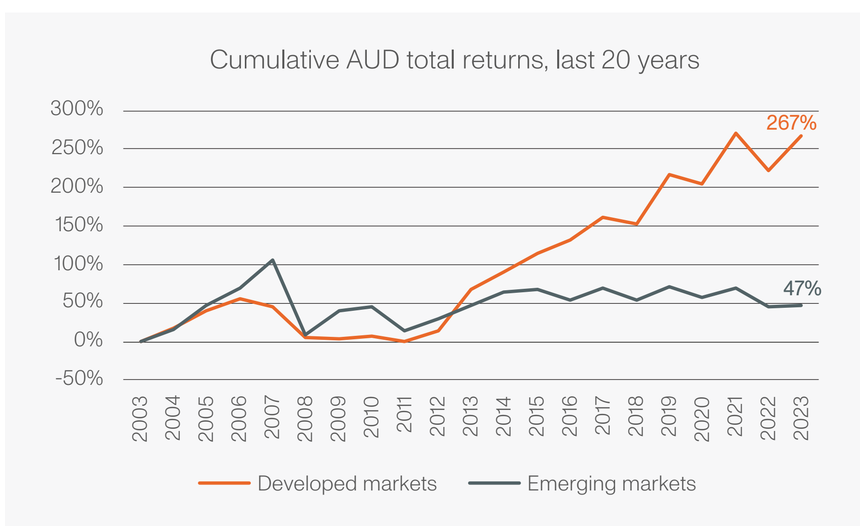
However, international investors are exposed to a laundry list of additional risks in these less developed economies:

- Persistently high inflation and currency depreciation. These detract from investors' returns when converted to their home currency.
- Corruption and poor rule of law. Companies based in emerging markets may struggle to protect their intellectual property or win business without engaging in bribery.
- Poor corporate governance. Many emerging market companies have opaque ownership structures, a high incidence of related-party transactions, and limited protections for foreign investors.
- Lower accounting and reporting standards. Investors may receive limited financial information and find it difficult to validate and trust the numbers they do see.
- Political instability and interventions. A recent example was in 2021, when the Chinese government decreed that for-profit private tutoring companies must now become non-profits, wiping out tens of billions of dollars of market value overnight.

The data shows that investors haven't been adequately rewarded for these risks.

Investors in emerging markets haven't been adequately rewarded for the additional risks they bear.

The group of companies based in emerging markets have underperformed those in developed markets in 15 of the last 20 years. Emerging market companies have returned on average just 1.9% p.a. in AUD versus 6.7% p.a. for developed market companies.



Investors don't need to bear all the additional risks of doing business in emerging countries to participate in their economic growth. Instead, they can choose to own businesses that operate around the world but are based in developed countries where the numbers are trustworthy and the rule of law is established and reliable.

4. Companies with volatile earnings

Companies that are highly cyclical, commodity-based, or heavily influenced by macroeconomic conditions – such as mining companies, energy producers, banks, and airlines – tend to have highly volatile earnings. Investors may be drawn to these businesses believing they can correctly predict economic cycles, or because they seem to trade on low valuation multiples.

Volatility in a company's earnings can be a source of risk if it leads to poor decisions from both management and investors. Sometimes the journey matters as much as the destination.

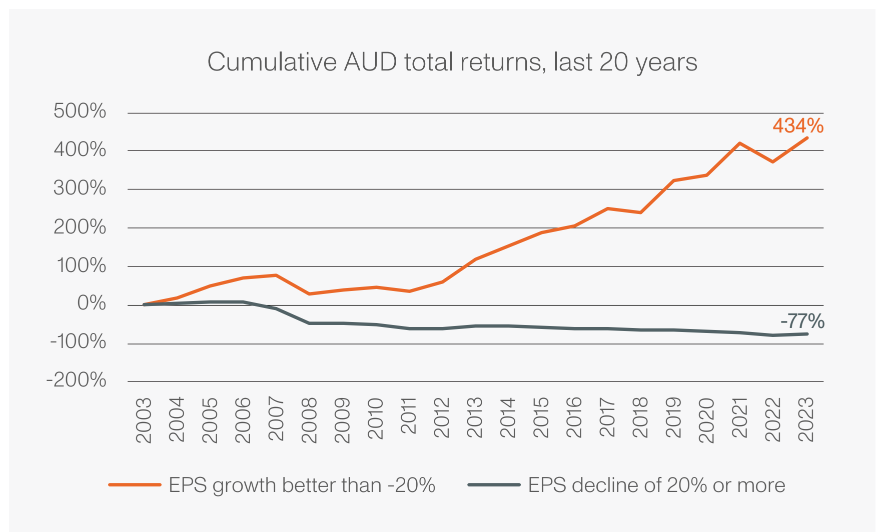
Imagine the difficulties in managing a business whose earnings go through frequent booms and busts. When customer demand is high, you may be tempted to increase production and hire more people to maximise profits. Companies also tend to make large acquisitions at the peak of their business cycle, when it feels like the good times may continue forever.

As conditions inevitably turn, a cyclical company can find itself with a bloated cost base. Management may need to cut costs, lay off people, sell assets, or even raise more capital. These decisions can cause long-term damage to the value of the business.

Investors go through a similar psychological rollercoaster. At the top of the earnings cycle they may become over-optimistic about the quality of a business and what it's worth. Then a downturn in earnings can shake their confidence in the business and make it difficult to stay the course with their investment, even if conditions eventually recover.

Companies that have experienced large earnings declines have significantly underperformed those with more resilient earnings.

Investors who owned a of companies whose earnings declined by 20% or more the prior year would have lost 75% of its value over the last 20 years. If a crystal ball allowed it to only own the companies with more resilient earnings, its capital would have grown more than 5x.



No company is completely immune to the environment in which it operates. But investors are likely to earn better long-term returns by owning businesses that are consistently profitable, even in cyclically weaker years, and where the difference between a good year and a bad year isn't extreme.

Conclusion – low-risk businesses are better investments

Contrary to common financial theory, investors who assume greater risk have not been rewarded with higher returns.

At Aoris, our investment approach is evidence-based. We believe the evidence shows that wealth is best created through the ownership of low-risk businesses that become more valuable over time. We aim to minimise the risk of permanent loss of our clients' capital by avoiding the types of businesses studied in this feature article:

- We won't own unprofitable companies. We own 15 market-leading businesses that have a long history of profitable growth and market share gains.
- We won't own companies with excessive levels of debt. We like businesses with strong balance sheets that can weather stressed conditions.
- We won't own companies based in emerging markets. We can still participate in the growth of these economies by owning globally leading businesses that operate around the world but are headquartered in countries with high standards of corporate governance and rule of law.
- We avoid businesses with highly volatile earnings. We like those that operate within a narrow range of outcomes and aren't unduly influenced by economic conditions.

We also don't look to compensate for high risk through price. We try to keep things as simple as possible by making fewer but highly considered investment decisions. We own 15 low-risk businesses that are easy to understand and where we can clearly evidence why they've been successful.

We believe this selective and conservative approach will continue to serve us and our clients well.

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