AORIS

Quarterly Report

September 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 30 September 2024

Class A (Unhedged – base fee option) Inception 26 March 2018	**September Quarter**	**1 Year**	**Since Inception p.a.***
Portfolio return (AUD) net of all fees	3.1%	26.3%	15.9%
MSCI AC World Accum Index ex-Australia (AUD)	2.6%	22.6%	12.1%
Excess return	0.6%	3.7%	3.8%

Class C (Hedged – base fee option) Inception 28 September 2018	**September Quarter**	**1 Year**	**Since Inception p.a.***
Portfolio return (AUD) – net of all fees	4.0%	29.4%	13.2%
MSCI AC World Accum Index ex-Australia 100% Hedged (AUD)	4.6%	28.6%	9.4%
Excess return	-0.6%	0.8%	3.8%

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

Market and portfolio performance

The international equity market, as measured by the MSCI AC World Accumulation Index ex-Australia, rose by 2.6% in the September quarter (all returns are in A$ unless stated otherwise). Equity markets appreciated by 4.6% in local currency terms, while changes in currency values detracted 2.0% from the A$ return.

As shown in the table on page 3, the Aoris International Fund (Class A – Unhedged) returned 3.1% for the quarter, 0.6% ahead of its benchmark. The Aoris International Fund (Class C – Hedged) returned 4.0% for the three-month period, which compares to 4.6% for its benchmark.

Sector performance in the September quarter was quite different from the last few quarters, when Information Technology (IT) had been the stand-out gainer. The best-performing sectors globally in the three months to September were Real Estate and Utilities (both up more than 12%), followed by Telecommunications. These are all industries that we choose to avoid for several reasons, including low structural growth, high financial leverage, and poor returns on capital for most companies. We believe we will be better placed looking elsewhere to deliver the 8–12% p.a. return we aspire to achieve over the long-term. The two worst-performing sectors for the quarter were Energy and IT, both of which declined.

The two strongest contributors to Fund performance in the quarter were MSCI Inc. and Accenture, with gains of 17% and 13% respectively.

- **MSCI Inc.** – We purchased MSCI in early May after a March quarterly earnings result that was negatively impacted by the merger of two of its large clients. MSCI's share price has since responded positively to a return to more normal sales growth, as well as investor recognition of its strong position in climate data and related investment solutions.

- **Accenture** – Accenture is well positioned to help its large corporate and government clients modernise their IT infrastructure, improve their operating efficiency, protect their data, and benefit from generative artificial intelligence (AI). The growth in Accenture's relevance and the depth of its customer relationships is reflected in the number of contracts it has been awarded that have a value of over $100 million. The number of new such customer commitments increased to 33 in the fiscal quarter ended August, from 26 in the same period a year ago.

The three primary detractors from performance in the quarter, each of which declined by around 7%, were Microsoft, Copart and Amphenol.

- **Microsoft** – There is some market sensitivity to Microsoft's rapidly increasing capital expenditure, which amounted to US$44.5 billion in the year to June, roughly double the amount of two years earlier. Much of this spending is to allow Microsoft to grow its Azure cloud-computing business, including its AI-related services. We are comfortable that Microsoft is investing to meet strong underlying demand and that it will earn a good return on its considerable investment. As a measure of customer demand, the *New York Times* reported that 350 million people used ChatGPT during the month of June, up from 100 million in March. ChatGPT runs exclusively on Microsoft Azure.

- **Copart** – Copart's primary business is auctioning damaged vehicles on behalf of auto insurers in the US. There is some investor concern that recent weakness in used car prices will negatively impact Copart's revenue. The company's long-held view is that used car prices have a broadly neutral impact on their profitability, with periods of weaker prices offset by increased auction volume, and vice versa.

- **Amphenol** – Amphenol's recent share price softness follows a gain of 59% in the year to June. Amphenol is a world-leading connector and sensor business, and is benefiting from strong demand in markets such as data centres for cloud computing and electric vehicles. Amphenol also continues to outgrow its end markets, and adds value to shareholders through sensible acquisitions.

The US labour market is tightening, with broad implications

During the quarter, port workers on both the east and south coasts of the US went on strike together for the first time in nearly 50 years. The dispute was ended in just three days, with workers tentatively agreeing to a wage increase of 62% over six years. This was less than the 77% they had asked for, but more than the 50% that was initially offered.

The port strike may tell us something broader about the labour market and the direction of wages, not just in the US but in many developed economies. Currently there are more job openings in the US than unemployed people, which represents a sharp tightening of the labour market relative to the 2000s and 2010s. An ageing population, more people choosing to retire early, and fewer young people entering the workforce, all indicate that the supply of labour may become increasingly scarce relative to demand in the years to come. Workers in many industries may find they can now demand inflation-busting pay rises, just as port workers have.

Labour market tightness won't affect all businesses equally. Leading companies growing in a durable manner can offer their staff career advancement opportunities, and will therefore be far better placed to attract and retain workers than the average employer. Companies with strong corporate values and a track record of investing in their people will be able to manage labour scarcity better than their peers. Lastly, businesses that provide products and services that help other businesses operate more efficiently through productivity solutions will be well positioned for what lies ahead.

We believe many companies in the Aoris portfolio will benefit from tightening labour markets. For example:

- **Accenture** – Accenture's staff received an average of 44 hours per year of training last year – 10% more than the prior year – much of which was focused on AI skills. With healthy underlying growth and consistent market share gains, supported by a high level of investment in its employees, it's no wonder Accenture has a staff retention rate better than many of its peers.

- **Compass Group** – Compass is the world's largest contract catering organisation. Around half of all corporations, government departments, hospitals and universities globally, today self-operate their on-site catering. Many are turning to Compass to do it for them, to relieve them of the burden of managing increasingly scarce hospitality labour.

- **Copart** – Copart offers a number of services to auto insurance customers that complement its auctions, such as vehicle inspection, imaging, and title recovery. These are functions that insurers have historically done themselves, but Copart is seeing strong growth in demand as insurers struggle to find the resources internally.


GREY

Company profiles

Fastenal

Fastenal partners with its customers to help make their supply chains more efficient.

The supply chain disruptions of 2021 to 2023 were a stark reminder that the availability of critical components and consumables for industrial and commercial enterprises cannot be taken for granted, and not having them available when needed can be very costly.

Fastenal is a leading industrial distributor in the US. It has a remarkable long-term track record of profitable growth, having increased its sales and earnings per share by 8% and 10% respectively over the last 15 years.

Key to Fastenal's success is that it is not a distributor in the way you might think of FedEx or UPS. It doesn't simply drop a box at the customer's doorstep. Rather, it's a supply chain partner than can take responsibility to manage inventory levels for certain products at its customers' facilities, and replenish them without the customer having to manually monitor supply levels and place orders.

Fastenal provides inventory monitoring and restocking services in a variety of ways. This includes on-site vending machines that dispense products like ear plugs and safety goggles, bins with sensors that monitor inventory levels in real-time, and having Fastenal employees on site to physically monitor and ensure an adequate supply of critical inputs.

These services ensure that supplies are always available and reduce the quantity of inventory the customer needs to keep on hand, as well as the amount of labour they need to manage this inventory.

A study the company conducted over 2018 to 2021 found that on average, Fastenal reduced customer hours spent on sourcing by 51%, and the value of inventory held by the customer by 37%. Interestingly, Amazon, which is famously good at logistics and supply chain management, is one of Fastenal's largest customers.

Another ingredient to Fastenal's lasting success has been its culture and approach to hiring and retaining employees. Fastenal recruits only from colleges, typically from the mid-west, and promotes from within. It invests in training through its Fastenal School of Business and provides mentoring from its senior staff. After new hires have been with Fastenal for a couple of years, its employee turnover is extremely low.

We believe that the labour-saving services Fastenal provides to its customers will only become more valuable, and its successful approach to hiring and retaining talent will become an even greater competitive advantage over time. We see many years of attractive, profitable growth ahead for Fastenal.

Diploma

Similar in some ways to Fastenal, Diploma is a UK-based, value-added distributor that operates across a variety of countries and end markets.

Diploma distributes specialised products that are critical components in its customers' value chains. These are products that cannot fail and must be delivered on time. The company thrives in offering solutions that are technical or can survive harsh, demanding operating conditions.

Diploma comprises a diverse set of 16 businesses. Common across them is the value provided through deep technical support; the product itself, perhaps through customisation or packaging; and responsive customer service.

Diploma is another specialty distributor whose solutions provide cost and labour savings for its customers.

To illustrate its service proposition, take Diploma's Windy City Wire subsidiary, which is a US-based distributor of low-voltage wire and cable. When building a new data centre, for instance, the contractor will lay hundreds of metres of various cables. Another distributor may supply a huge drum of wire that the contractor has to unspool, one strand at a time. Often this turns the project into a two-man job. Windy City Wire can provide a preconfigured kit, with wires cut to the required lengths and on an easy spooling mechanism that can be operated by a single person, reducing labour costs for the customer by 20–30%.

Another interesting Diploma business is Tennessee Industrial Electronics (T.I.E.), which operates in the industrial automation market in the US. It provides refurbished parts for Fanuc robotic arms that are no longer under warranty. T.I.E. has an inventory of over 100,000 parts, including hard-to-find parts and older vintages. T.I.E. will also refurbish Fanuc robots, including repainting them to their original colour scheme.

Another important contributor to Diploma's growth over many years has been its highly successful bolt-on acquisition program. Through a combination of very profitable internal growth and acquisitions, Diploma has increased earnings per share by 15% p.a. over the last 15 years. We believe the company can continue to grow earnings at a double-digit rate over the coming years.

Portfolio Changes

Purchases

Diploma PLC

As described in a separate section, Diploma is a distributor operating across a variety of industrial and life science end markets. It focuses on distributing specialised products that are critical components in its customers' value chains. In all areas it operates, there is a strong service component, and the value provided to the customer is high relative to the price charged. Diploma has achieved very attractive underlying growth in sales and earnings over many years, on top of which it has consistently added to earnings and shareholder value through bolt-on acquisitions.

Sales

Cintas

We sold Cintas early in the quarter solely due to its valuation. We had owned Cintas since the inception of the portfolio in March 2018, and since that time the share price had increased by approximately 5x. Cintas is a business we admire greatly and one we hope to have an opportunity to own again, should its valuation become more attractive.

The Illusion of Safety

Written by Alfred Tadros,
Portfolio Manager

Introduction

Sectors that appear 'safe' in the short term may carry longer term risks.

Rising geopolitical tensions, the US Presidential election and a possible recession are some of the concerns currently dominating news headlines and preoccupying investors. In uncertain times, investors may be tempted to move their equity investments into sectors that are perceived as 'safe' or 'defensive'.

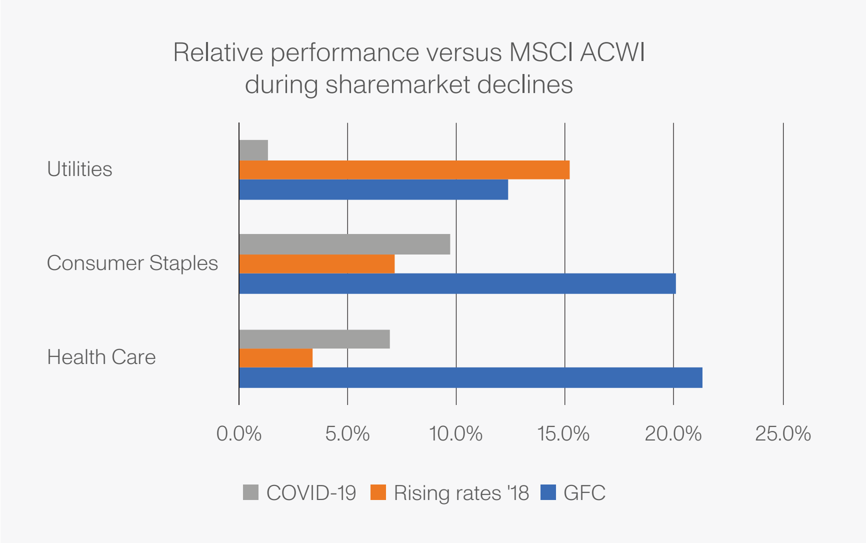
These 'defensive' sectors include the likes of Health Care, Consumer Staples, and Utilities. They appeal to investors because they deal in goods and services considered to be essential and economically insensitive, and are thus seen as a safe home for investors' capital during difficult periods.

In this quarterly feature, we discuss some trade-offs investors might be making when investing in these sectors. Sectors that appear safe in the short term may carry longer term risks that aren't immediately apparent. We describe this as the 'Illusion of Safety'.

We then discuss our approach to both preserving and growing the wealth of our clients, right across the market cycle.

Why investors gravitate towards defensive sectors

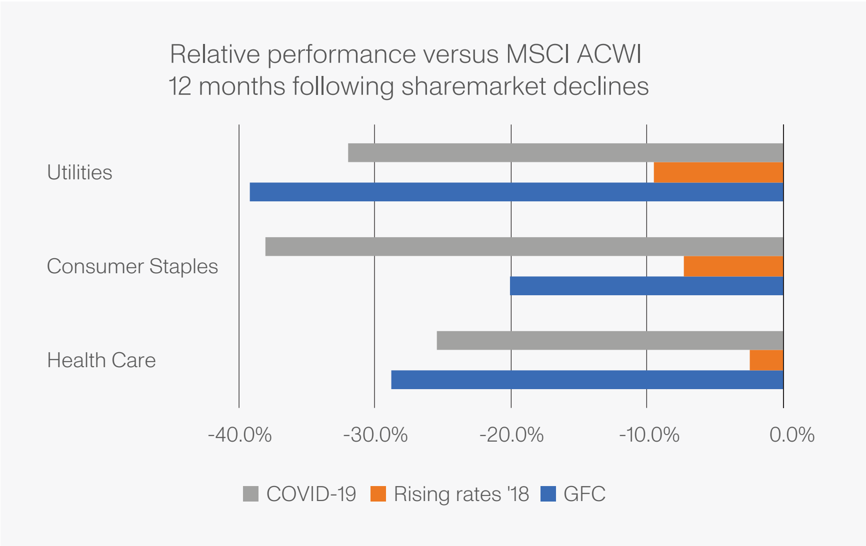
We researched the performance of all global sectors during the peak-to-trough period of three severe sharemarket declines: the GFC, the start of rising interest rates in the US in 2018, and the COVID-19 pandemic. In all three periods, three of the best-performing sectors were Health Care, Consumer Staples and Utilities.



Source: FactSet, MSCI, Aoris analysis
GFC: Oct 2007 – Mar 2008; Rising rates: Sep 2018 – Dec 2018; COVID-19: Feb 2020 – Mar 2020

Perceived safe sectors have typically underperformed the market over recent periods of severe declines to recovery.

However, interestingly, they were consistently among the worst-performing sectors in the 12 months *after* each market decline. Across the entire period of market decline to recovery, they also typically underperformed the broader sharemarket.



Source: FactSet, MSCI, Aoris analysis

Why might that be the case?

When people are faced with bad news, it's natural for them to be reactive in a way that brings them comfort in the short term. This is what happens when investors move their capital into 'defensive' sectors during a market sell-off. But in the following few pages, we highlight some of the longer term risks of investing in these sectors, which investors may be overlooking.

Health Care

We have all at some point relied on healthcare products to alleviate pain, mitigate some condition or to improve our quality of life. Health care touches all our lives in some way, whether it's using health insurance, prescription drugs, medical devices, or a night in hospital after a tumble on the ski slopes.

Our demand for health care only increases as we get older, and the global population is ageing. So, it's no surprise that investors see Health Care as a defensive sector with stable if not rising demand and profits.

However, there are some aspects of the healthcare industry that may present greater risks than investors appreciate.

1. Government bargaining power

Healthcare systems are notoriously complex and opaque, meaning governments and patients may face higher costs than they should. Governments around the world are focused on reducing the cost of their public health systems, especially when faced with ageing populations.

Governments are focused on reducing drug costs.

One way they're doing this is by using their position as the largest buyer of prescription drugs to negotiate lower prices. The imperative is clear. As an example, according to the Rand Corporation the cost of prescription drugs in the US is about 2.5x the average drug prices paid by a group of 32 other countries.

The governments of the US, UK, and Germany are each addressing drug pricing in different ways:

- **US**: The Inflation Reduction Act (IRA) of 2022. The IRA allows the US government's Medicare agency to negotiate directly with pharmaceutical companies over the wholesale purchase price of 10 leading drugs, which is expected to save the government $100 billion over the next decade. More drugs will be added to the list over time.

- **Germany**: The Federal Ministry of Health mandates price discounts from drug companies intending to sell to statutory health bodies in what is Europe's largest healthcare market. Last year it increased mandatory drug discounts from 7% to 12%, and extended a 2021 price freeze that had been due to end in 2022, through to 2026.

- **UK**: The UK's National Health Service levies taxes to set the effective price for branded medicines that seek access to the public health system. Last year it increased the tax on branded medicines from 5% to 26%, in order to limit price increases to 2%.

It's clear there's pressure from governments around the world to address the cost of prescription medicines. The most consequential changes in policy are in the US, which is a major profit centre for pharmaceutical companies.

2. Patent cliffs

Investors may believe that investing in pharmaceutical companies allows them to benefit from ever-rising demand for their latest innovations. However, a perennial risk faced by these companies is patent cliffs – when they lose patent protection for their products.

This introduces competition, affecting the growth of their revenues while new drugs may be unable to fill the gap. It is not uncommon that pharmaceutical companies' share prices underperform the market for years as they navigate the end of patent protection for their leading products.

Patent cliffs can reduce product revenues by 90% when competition arrives.

Once patent protection for drugs end and generic competitors become available, they can see price declines on their products of over 90%. The most well-known example of a patent cliff is Pfizer's cholesterol-lowering drug Lipitor. At its peak, Lipitor generated more than $12 billion in annual sales. Sales then fell by 90% when its patent expired and generic versions flooded the market.

New drugs are becoming more expensive to develop and less successful when launched.

New drugs developed to replace those that face generic competition may be less impactful from both a revenue and profitability perspective. Not only are the costs of developing new drugs rising, but the trend is also that they produce lower revenues. And that is *if* they are eventually approved – only 12% pass Food and Drug Administration (FDA) requirements in the US.

- **Rising drug development costs**: The Tufts Centre for the Study of Drug Development estimated the average cost of developing a new prescription drug was $2.9 billion in 2016, compared to $803 million in 2003.
- **Declining research productivity**: Spending on research & development is producing less financially attractive drugs. According to Deloitte, peak sales per pipeline asset has fallen from $816 million in 2010, to $362 million in 2023.

The combined effect of rising drug development costs, falling research productivity, and low drug approval rates is that pharmaceutical companies might find it harder to grow profitably, and less able to withstand the end of patent protection.

3. Litigation

It would appear the profit motive of healthcare companies often clashes with the proper provision of health care for patients. This can be seen in the frequency and cost of litigation faced by them for inappropriate selling practices, such as misrepresenting the risks of their products or incentives related to referrals.

Litigation introduces reputational as well as financial risk. Few investors would wish to see their investments splashed across the front pages of newspapers for poor behaviour.

This has been highlighted by pain relief drugs, leading to what has been described as an opioid epidemic in the US. Government statistics estimate this epidemic has unfortunately claimed over one million lives through overdose since 1999, becoming a major political and legal issue. At the heart of the crisis is a failure of healthcare companies to properly inform users of the addictive nature of opioids and a pattern of over-prescribing these medications.

The opioid epidemic highlights the costs of the industry's misselling practices.

The subsequent legal settlements and fines have reached tens of billions of dollars, touching many parts of the healthcare industry, including manufacturers, medical distributors and pharmacy chains. The most notable case was the $26-billion settlement in 2021 against three major pharmaceutical distributors – McKesson, AmerisourceBergen, and Cardinal Health – and manufacturer Johnson & Johnson.

Far from being an isolated episode, there are many prior examples of litigation affecting other healthcare players, such as medical device companies. The reasons the industry faces such frequent litigation are likely multi-faceted but it is a risk that appears pervasive.

In summary, investors see healthcare companies as rising profit streams due to our need for their products and services that rises as we get older. However, we believe that government action on drug pricing introduces new risks, while patent cliffs and litigation continue to be ever-present risks.

Consumer Staples

Consumer Staples companies manufacture products considered essential by consumers, such as food, beverages, personal care products, and homecare products. As with Health Care, investors are attracted to this sector by the stable demand for their products.

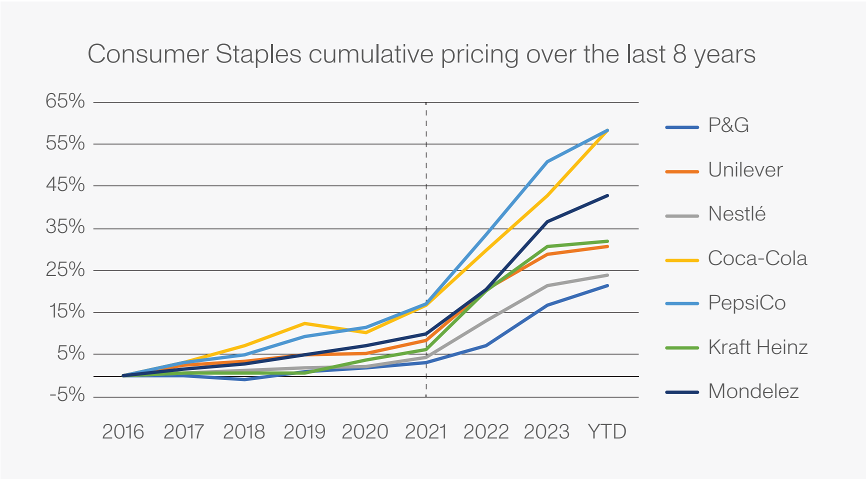
Looking forward, we see a few ways in which these businesses may experience slower growth and be less resilient than they've been historically, which may lead to disappointing outcomes for investors.

1. Unsustainable pricing

Many consumer brands invest huge sums of marketing dollars to make their brands widely recognisable, and so consumers are willing to pay a premium price for their products compared to non-branded goods, often known as 'private label' or 'store brands'.

Consumer Staples companies are also generally able to withstand cost inflation and operate with stable profit margins because of their ability to raise prices. This can take the form of 'shrinkflation', where they charge the same or more for a lower quantity; like-for-like pricing, where the same can of Heinz baked beans costs more than it did a year ago; and charging more for products with different functionality, such as dishwashing tablets that cost more than powdered versions.

In the high-inflation environment of the last few years, Consumer Staples companies have been exerting these forms of pricing to preserve or even expand their profit margins. The chart following shows the pricing development of some well-known Consumer Staples companies over the last eight years, based on their public disclosures.



Source: Company filings, Aoris analysis

Recent dramatic price increases by brands are seeing pushback from supermarkets.

Prior to the COVID pandemic, these companies were regularly raising their prices by about 1–2% p.a. However, during each of the last two years price increases have ranged from 4%–14%.

This pricing behaviour feels unsustainable to us. We have already started to see consumers respond to this sticker shock by reducing their spending, which has led Consumer Staples companies to report slowing volume growth, as well as a pushback from supermarkets in implementing the proposed price increases.

In September 2023, Carrefour, one of Europe's largest retail and supermarket groups, took a stand against major food manufacturers, including companies in the chart above, for engaging in 'shrinkflation'. Carrefour placed warning labels on products, ranging from Lay's potato chips (produced by Frito-Lay, owned by PepsiCo) to Lipton Iced Tea (distributed by Unilever). Eventually, the Consumer Staples companies yielded and agreed to reduce the magnitude of their price rises.

Similar disputes have arisen in other countries. The supermarket chains Tesco in the UK, and Loblaw in Canada, both completely removed Frito-Lay and Kraft Heinz products from their shelves because of high proposed price increases, before eventually agreeing on lower increases.

The risk is that the Consumer Staples companies may not have the pricing power they once did, which may impede their ability to preserve their high margins.

2. Increasing market share of private label products

There are limits to how much consumers are willing to pay for brands. A logical response by consumers in the face of cost-of-living pressures is to switch to lower priced private label products.

Private label dishwashing tablets, hand soap or foodstuffs are often just as functional as the branded equivalent but cost about half the price. Sometimes, private label products are even made by the same company as the branded goods! (Not that they'd want you to know.)

Major supermarket retailers have significantly expanded their range of private label products in response to rising consumer demand. They have also focused on enhancing the quality and packaging of their store brands, to alleviate the stigma around their quality and appearance, and allow them to compete more directly with the well-known brands.

- **Walmart** recently launched its widest selection of private label foods in 20 years, under the brand bettergoods. Bettergoods offers on-trend food recipes, and organic and plant-based food options, which are all priced below $5.

Today, Walmart's store brands represent 20% of its revenue, and over 30% of revenue at its warehouse club format, Sam's Club. Recently its private labels have been growing as a proportion of its revenue by around 2% a year.

- **Costco's** private label brand, Kirkland Signature, offers products that are at least of equivalent quality to the well-known brands but 20% to 40% cheaper. Far from being the private labels we grew up with, Kirkland is often awarded for its best-in-class products. Kirkland represents 30% of Costco's revenue and has been growing as a proportion of its revenue by around 1% a year.

Private labels are gaining market share as consumers respond to rising prices.

Recent reports by the Private Label Market Association industry body show that private label penetration in US consumer packaged goods has risen above 20% of industry revenue for the first time ever, compared to 16% a decade ago. Private label's share of industry volume is even higher at 22%, given their lower prices.

An accelerating loss of market share to private label products will likely impact the growth prospects for Consumer Staples companies and may negatively affect their margins by forcing them to become more price competitive.

In summary, Consumer Staples companies have traditionally been stable growers and are thus seen as safe investments by investors. However, we believe their future may not look like the past due to their dramatic pricing actions of the last few years, and the logical response by consumers to shift their spending to private label products.

Utilities

Utilities supply electricity, water and gas services to households and businesses. Demand for their services tends to be stable regardless of economic conditions. Utilities also typically operate under long-term agreements with regulators, which outline the prices and profits they're allowed to earn.

Stable demand and long-term visibility into their earnings allow Utilities to produce steady cashflows and they can pay regular dividends to their investors. Utilities are therefore considered safe preservers of wealth.

However, we believe the predictability of Utilities' earnings and their ability to pay dividends is less certain than investors may expect. Here's why.

1. Changing the rules of the game

The regulated pricing regime of Utilities can change due to politics.

Regulators determine what prices Utilities are allowed to charge and can change their minds, including for political reasons.

A recent example of this occurred in the UK energy market in 2022, when the Conservative government introduced price caps on energy bills in response to public outcry over the cost of living.

The effect on Utility companies was reduced profitability, because they were unable to pass on the cost of higher power prices to consumers. Public investors in these companies also suffered – the UK Utilities sector index fell by 23% in just two months between August and October of 2022.

Utilities may be required to make large investments that affect their cashflows and dividends.

Additionally, regulators can impose increasing costs on Utility businesses, whether it be to meet new environmental standards or to correct perceived underinvestment.

For example, the EU Commission's energy transition plan called 'Fit for 55' targets reducing net greenhouse gas emissions by at least 55% by 2030.

To meet this commitment, EU member states are imposing demands on their national Utilities to invest in the use of clean energies and to close down current coal-fired power plants. Here are notable examples:

- **E.ON**, Germany's largest utility, has been required to invest heavily in its power infrastructure to accommodate the growing share of renewable energy, particularly from wind and solar sources, which are more intermittent. It has also committed to phasing out its remaining coal plants to transition to these cleaner energy sources. The total cost of the investment plan is estimated at €27 billion over the five years from 2022 to 2026. The company's entire market value today is just €35 billion.

- **Enel**, Italy's largest utility, has been required to phase out coal-fired power plants and replace them with cleaner energy alternatives by 2035. Over the next decade, Enel has committed to investing more than €70 billion in renewable energy projects and making power infrastructure improvements. That's as much as its entire market value today.

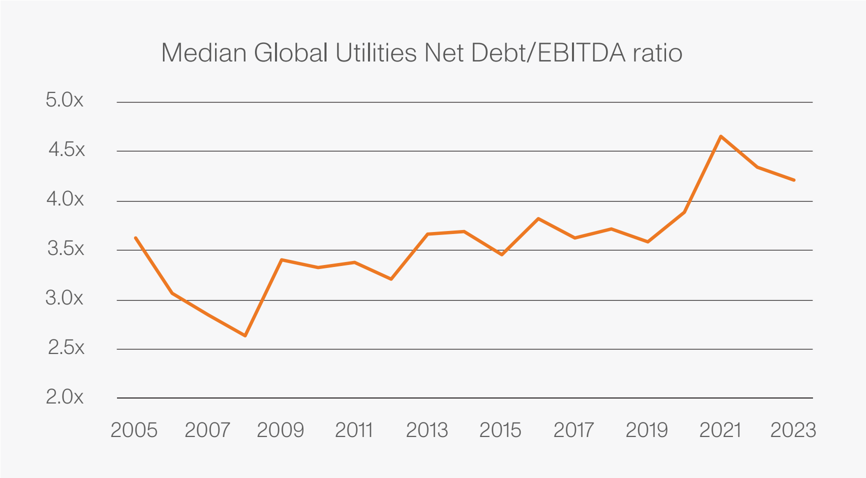
As a result of these investment plans, both companies have increased their investment spending and have reported negative cash flows, with dividends payments exceeding net profits. In fact, Enel has been forced to reduce its dividend payout ratio, to accommodate these investments and lower its debt levels.

2. High debt levels

Management of Utility companies also tend to believe in the stability and longevity of their companies' earnings. As a result, Utilities tend to be funded with much higher levels of debt than the average business.

High debt levels leave Utilities vulnerable to changing regulation and rising interest rates.

The chart below shows the historical ratio of Net Debt divided by EBITDA for the global Utilities sector, which is a common measure of debt levels. Utilities have 2–3x higher Net Debt/EBITDA than the average global business ratio of around 1.5x.



Source: FactSet, Aoris analysis

These high debt levels leave Utilities with little margin of safety if they were to experience adverse changes in pricing or higher investment requirements.

High debt levels also make Utilities vulnerable during periods of rising interest rates. Regulators may not allow the Utilities to increase their prices at a high enough rate to cover their higher interest expenses. This is entirely out of their control.

In summary, rather than seeing regulation as a source of comfort for Utilities, we believe it's more likely to be a source of risk. Changes to regulation and interest rates can negatively affect Utilities' balance sheets, cash flows, and their ability to pay dividends.

Conclusion

In the previous pages we've highlighted longer term risks that investors should be cognisant of when investing in the Health Care, Consumer Staples and Utilities sectors. These risks may lead to a disappointing outcome in the sectors that investors imagine to be safe.

- The healthcare industry faces underappreciated risks, including drug pricing pressures, patent cliffs, and litigation. Globally, governments are pushing for lower drug prices, while patent cliffs can drastically reduce revenues when generics enter the market. The combination of rising development costs and vulnerability to litigation add further financial and reputational challenges.
- Consumer Staples are grappling with changing market dynamics and increased competition from private labels, which might necessitate a re-evaluation of their pricing strategies.
- Utilities, typically seen as stable, are vulnerable to regulatory changes and environmental pressures, the costs of which could threaten their financial health and ability to deliver consistent returns.

Our approach: Safety through quality

Safety to us means owning high-quality, wealth-creating businesses. These wealth-creating businesses have common, identifiable characteristics:

- They have durable competitive advantages and we can evidence their lead over competitors becoming wider.
- Their products and services provide measurable benefits to their customers, with modest price increases relative to the value offered. We refer to this as a 'high value-to-cost ratio'. This is a mindset that fosters customer goodwill, increasing the lifetime value of the relationship.
- They invest continuously to enhance their customer offerings, ensuring the value they provide to customers increases over time.
- They operate in industries where there isn't an outsized impact from the role of regulation.
- They have conservative balance sheets, which at times of economics stress is a competitive advantage.

These characteristics provide us with confidence in their continued growth and profitability in the years ahead.

Portfolio companies

accenture

Amphenol

Atlas Copco

CDW

COMPASS GROUP

Copart

DIPLOMA PLC

experian

FASTENAL

Halma

L'ORÉAL PARIS

Microsoft

MSCI

RELX

VISA

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