

September 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% p.a. over a market cycle.

Our Quarterly Reports

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

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

Each quarter we include a Thought Piece or *feature* on a topic area with direct relevance to our investment approach.

Aoris International Fund

Performance to 30 September 2018 - Class A

	September Quarter	Since Inception*
Portfolio Return (AUD) - Net of all fees	6.2%	11.5%
MSCI AC World Accum Index (AUD)	6.6%	11.7%
Excess Return	-0.4%	-0.2%

*Inception date: 26 March 2018, annualised. Past performance should not be taken as an indication of future performance.

MARKET AND PORTFOLIO PERFORMANCE

The Fund returned 6.2% for the quarter, a pleasing absolute return and just behind our benchmark.

Five stocks were up by over 10%, led by Nordson's 12.7% gain.

The international equity market, as measured by the MSCI AC World Index ex-Australia, appreciated by 6.6% over the three months to the end of September (all returns are in AUD unless stated otherwise). Of this, 1.8% can be attributed to the impact of the lower AUD and 4.8% from local currency appreciation of overseas equity markets. Developed markets were up by 7.2%, the US leading the way with a 9.6% gain led by large tech stocks. Japan put on 5.9%, while Europe rose 3.9% and the UK was marginally positive, held back by Brexit tensions. Emerging markets rose by just 1.0% as the risks of high debt levels and contracting US dollar liquidity began to bite in some countries. China was down by 5.6%, Greece by (another) 15.8% and the Turkish market lost almost a fifth of its value. Latin America was up by close to 10%, helped by a strong rebound in oil prices.

Looking at returns by sector, Health Care was up by 13.2%, as fears of pressure on pricing of pharmaceutical products and services abated. Led by the heavyweights, IT was up 8.3%, while Industrials rose 8.2%. Utilities, Materials and Real Estate lagged with only modest gains.

The Aoris International Fund (Class A) returned 6.2% for the quarter, 0.4% behind our benchmark. Pleasingly, five of our 15 stocks were up by 10% or more and none declined.

Key positive contributors

The largest positive contributors to the Fund's performance in the quarter were CDW and Nordson, up 12.7% and 10.9% respectively. Idex Corporation rose by 13.0%, while 3M and Amphenol were each up by over 10%. CDW was a significant positive contributor in the March quarter and we discuss this excellent company in detail at the end of this report.



Stephen Arnold
Founder & CIO

In an environment of rising tariffs and cost inflation, superior companies can protect profit margin through pricing power and internal operating efficiencies. IDEX and Amphenol are particularly good examples.

Nordson is a manufacturer of highly engineered dispensing and extrusion products. These are used in applications such as dispensing adhesives into electronic devices and the sealing of consumer goods packaging, and the extrusion of plastics to make medical device components and plastic film. While Nordson's result for the June quarter reflected some year-over-year softness in markets such as automotive construction, the company's durability is reflected in the fact it has increased its dividend for 55 consecutive years.

IDEX supplies highly engineered products into a variety of niche industrial markets where barriers to entry are very high and IDEX typically has market positions. These end markets include specialty valves and pumps that are used in process industries, components used in analytical and diagnostic instruments, and firefighting pump and foam systems. IDEX reported a strong June quarter with underlying growth of 9% and significant margin expansion. The company is seeing cost inflation from labour, raw materials and tariffs, but it also has a long history of successfully pricing ahead of cost inflation.

Amphenol, which we discussed in depth last quarter, is a leading producer globally of electronic connectors. Not only is the company benefiting from the growing penetration of electronics - from automotive to industrial and aerospace markets - but it continues its long history of significantly outgrowing its end markets. In the June quarter Amphenol reported an outstanding result, with underlying revenue growth of 13%. This included 27% growth from the mobile device segment and 17% growth from industrial markets. The company also continues its long and successful history of adding 4-5% of revenue per year through bolt-on acquisitions at valuations that generate high returns on invested capital.

3M rose strongly in the quarter on no particular news, reversing weakness from the prior three months.

Key negative contributors

The laggards for the quarter were RELX and Atlas Copco, up by 0.6% and 0.8% respectively.

RELX is a provider of a variety of professional information solutions. A significant business is peer-reviewed academic journals, where RELX is the largest publisher in the world. For many years there has been some tension between the funders of academic research, particularly in Europe, some of whom wish to have their research published in a form that is available for anyone to access, not just paid subscribers. In the last couple of months this has reared its head again with a coalition of European research funders seeking to mandate that all research they fund be published in 'open-access' journals by 2020. There are many obstacles to 'inverting' the academic publishing model, not least of which is the demonstrably lower quality of vetting that exists in the open-access environment. Nevertheless, this is a development we are watching closely.

Atlas Copco is a leading maker of air compressors used to create power in a range of industrial and construction applications and to produce ultra-clean air for applications such as semiconductor manufacturing. While there is certainly a degree of cyclicity in their end markets, Atlas Copco has for many years successfully managed this through a flexible, asset-light manufacturing model and a management culture that prioritises having the organisation ready for adverse environments rather than predicting them.

Feature - Growth vs. Value

INTRODUCTION

In this feature we examine whether there is any validity to the assumptions that underly the terms 'growth' and 'value'. We find these assumptions wanting.

The finance industry loves labels: Nifty-Fifty, TMT, BRICS, FANGS, Next Eleven and Fragile Five to name a few. They become an accepted part of financial market nomenclature for a period, then most disappear from conversation, a bit like the Atkins Diet, and eventually become quaint markers in time that help to define an era.

The terms 'growth' and 'value', however, have had more staying power and are used extensively in financial market commentary. Frequently we read that 'growth is outperforming value', a particular investment firm is a 'value manager', or a certain company is a 'growth stock'. These terms are used in ways that suggest you can divide stocks and investors into two opposing tribes, like Democrats and Republicans or the Montagues and the Capulets. These distinctions are nonsense. They are helpful neither in understanding the character of particular investments, nor the character of specific investment managers.

The first reason these labels lack genuine meaning is the absence of a universally-accepted definition. Let's jump over this hurdle by picking one. Standard & Poor's (S&P) creates indexes that quantitatively select stocks based on specific characteristics or 'factors'. Its factor indexes define growth and value each based on three variables:

Growth

1. Three-year growth in sales per share
2. Three-year growth in earnings per share
3. Price momentum

Value

1. Price-to-book
2. Price-to-earnings one year forward
3. Enterprise value-to-cashflow from operations

With the benefit of a definition, let's now look at the significant shortcomings of each label.

GROWTH

The notion of a 'growth company' and hence a 'growth investor' seems obvious. Surely it's as easy as picking the businesses that will generate faster than average EPS growth. We find that it's not that simple.

*There is **no** relationship between past sales growth and future earnings growth.*

The S&P US Growth Index is designed to capture those stocks whose earnings are expected to grow at an above-average rate. Let's look at whether the three growth variables do indeed correlate with future earnings growth.

1. Three-year growth in sales per share

The relationship between actual sales per share growth and future earnings per share (EPS) growth is not linear. In fact, there isn't one. To explore this, we took the 733 US companies that have a market capitalisation greater than US\$5b and more than seven years' history as a listed company. We divided them into five groups ranked by annualised sales growth over 2011 to 2014 and looked at the EPS growth over the following three years.

Sales growth 2010-13 vs. EPS growth 2014-17



Source: Factset

The absence of any correlation is clear. Historic sales growth (in the blue bars) tells us nothing about future earnings growth (in orange). Interestingly, and perhaps counterintuitively, the companies that had grown sales per share in the *fastest* tier, with a median growth of 21.4%, generated EPS growth at a rate materially below tier 2, whose sales growth was about half as fast. Median earnings growth barely differed between sales growth in quintiles 1, 3 and 4. Moreover, comparing the

fastest and slowest growing quintiles, three-year annualised sales growth differed by almost 25% p.a., yet this translated to a difference in EPS growth of just 1.7% p.a.

Rapidly expanding businesses often run into trouble. The graph below shows that of the group of companies with the fastest sales growth over three years to 2016, one in ten of them generated a loss in the following year, far higher than the middle three groups of ‘moderate growers’.

Companies growing their top-line rapidly are more likely to lose money than moderate growers.

Sales growth 2013-16 vs. loss makers 2017



Source: Factset

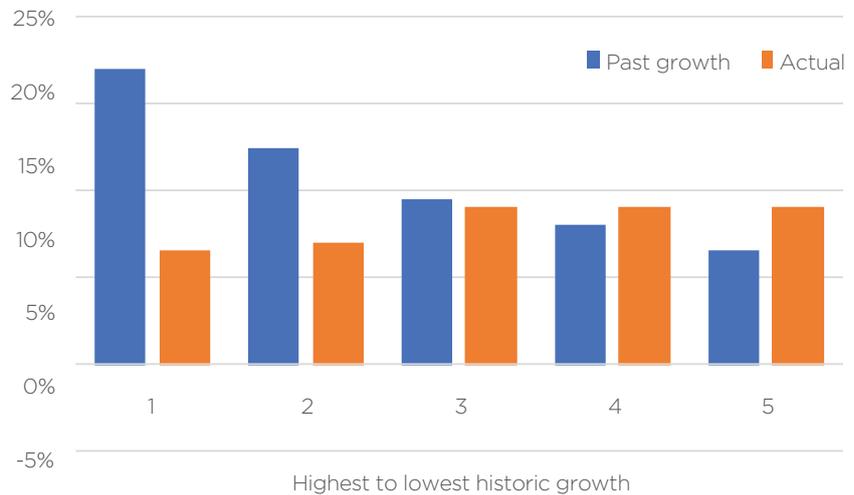
2. Three-year growth in earnings per share

If historic sales growth is no help as a predictor of future EPS growth, then perhaps historic EPS growth will do a better job.

Société Générale’s Global Strategy team examined the relationship between trailing five-year EPS growth and future five-year EPS growth over the 22 years to 2007 (published in *Value Investing* by James Montier, 2009). They found no positive correlation between past and future growth. In fact, firms with the highest historic EPS growth had, on average, the lowest future growth.

Past growth in EPS is of **no help** in predicting future growth.

Five-year EPS growth - Past vs. Actual US 1985-2007



Source: SG Global Strategy

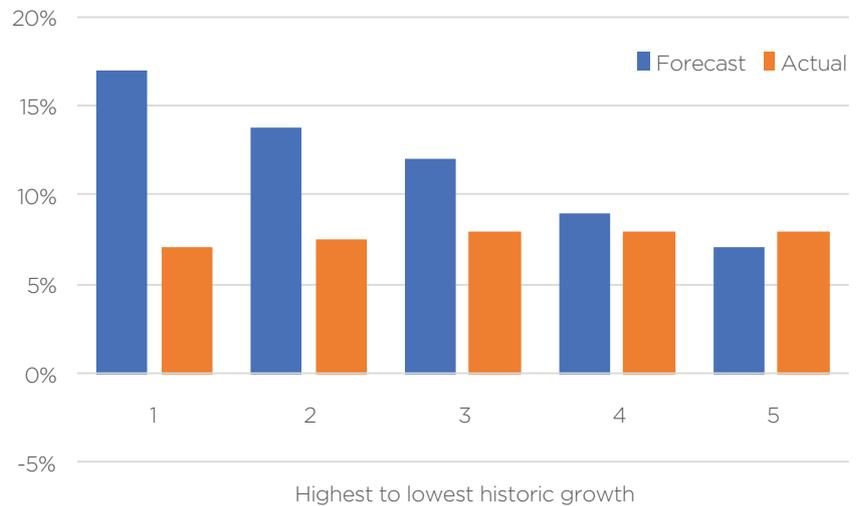
We believe in **evidence-based investing**. The assumptions underpinning 'growth' investing are not supported by evidence. The idea that businesses that will generate above-average future EPS growth can be easily and objectively identified is not supported by evidence.

Louis Chan from the University of Illinois looked at past and future growth in US companies over 1951 to 1998 ('The Level and Persistence of Growth Rates', *The Journal of Finance*, April 2003). He found that firms with superior EPS growth over three and five years did not show persistence into the following periods. So, as tempting as it may be to rely on it, historic EPS growth does not help identify companies with above-average future earnings growth.

If past growth can't quantitatively identify fast-growers, can analyst judgement do better? After all, most people would consider stock analysts to be experts in the companies they cover and financial forecasts to be central to their job. Sadly, sell-side analysts in general have no ability to distinguish fast-growers from the rest. Companies expected to grow EPS in the highest bracket generate growth that is, on average, different from those expected to grow at the slowest rate.

Analysts are, on average, unable to distinguish future fast-growers from the rest.

Five-year EPS growth - Forecast vs. Actual US 2008



Source: SG Global Strategy

3. Price momentum

Some academic literature supports historic share price performance, or ‘price momentum’, as a predictor of future price performance, and of price momentum being *explained* by earnings momentum. We have not, however, come across any research that supports price momentum as a *predictor* of future superior earnings growth. It may exist; we just haven’t found it.

Summary

The notion of ‘growth companies’ and in turn ‘growth investors’ has little to support it. As much as some might like to think that businesses that will generate high rates of EPS growth in the medium-term are easily identified, the evidence demonstrates that this is not the case. Above-average rates of achieved sales growth or EPS growth do not translate to above-average future EPS growth. Stock analysts show no ability in general to identify those businesses that will generate superior EPS growth.

‘VALUE’

Value seems a straightforward concept. Surely a cheap stock is one trading on a low multiple. Again, we show that this mental shortcut does not withstand scrutiny.

The S&P US Value Index is designed to identify ‘cheap’ companies. Let’s see if the three measures it uses can be expected to achieve that.

1. Price-to-book

In our June Quarterly, we discussed the deficiencies of equity, or book value per share, as a measure with any economic meaning. To summarise, shareholders’ equity, or book value, is an accounting residual, meaning it is the balancing item after assets and liabilities have been added up. A write-off of goodwill, for instance, will result in an equal reduction to book value and artificially increase the price-to-book ratio. Likewise, an increase in the discount rate used to calculate future pension obligations will result in an increase in book value. Book value per share is easily distorted and has no relationship to the value of a business.

2. Price-to-earnings one year forward

The ratio of price-to-forecast earnings seems a sensible way of separating cheap from expensive companies. However, it is deficient. Firstly, analysts in general cannot accurately forecast earnings, even one year hence. Further, analysts are systematically grossly optimistic – forecast growth is, on average, 50% higher than actual growth. So, a valuation ratio with forecast earnings in the denominator is flawed. Furthermore, the value of a business is a function of the cash it generates that is available to owners, not its accounting earnings. The difference between the two can be sizeable. Price-to-accounting earnings is a far less useful measure of value than price-to-normalised free cash available to shareholders.

3. Enterprise value-to-cashflow from operations

If it’s cash that matters, then perhaps this ratio will do the job. Enterprise value, or the sum of market capitalisation and net debt, relative to cashflow from operations is conceptually appealing. However, when applied mechanically using data drawn directly from financial statements it has considerable limitations. The reason for this is the denominator.

*A below-average multiple tells you where a stock trades relative to the market. It does not tell you what you need to know, which is where it trades relative to what it's **worth**.*

Cashflow from operating activities (CFO) is defined as:

$$\text{CFO} = \text{Net income} + \text{non-cash expenses} + \text{changes in working capital}$$

- **Non-cash expenses** – cash from operations adds back depreciation, but does not subtract capital expenditure. It adds back stock-option compensation, but does not deduct the cash the company must spend to offset the dilutions to existing shareholders from the options granted. Both adjustments are a bit like only counting the goals your team has scored.
- **Working capital** – the increases or decreases in inventory and the timing of payments of accounts payable and receivable can produce large swings in the cashflow statement independent of the underlying earnings performance of a business.

Thus 'cashflow from operations' produces a number that contains non-sensical add-backs, can vary wildly year to year, and deviate significantly from a business's economic reality, severely limiting its usefulness as a valuation tool.

Summary

All three of these 'Value' measures capture whether a stock trades on a high or low multiple relative to the market average. What these measures do not capture is where a stock trades relative to where it should trade; in other words, relative to its inherent worth. Designating stocks on below-average multiples as cheap, or 'value', and above-average multiples as expensive makes an implicit assumption that all stocks should trade on the same multiple. Knowing the price of one house relative to the price of another house tells you nothing – they might be of different size, different condition, perhaps even in different cities or countries. Knowing size, condition, location and so on, one can start to form a view of what they are worth. The most 'expensive' house may in fact be the cheapest, relative to its value. A low multiple does not mean a cheap stock.

CONCLUSION

*We don't believe in categorising stocks as growth **or** value. We believe in growth **in** value.*

'Growth' and 'value' are terms used with abandon, but they are terms without real meaning. 'Growth' implies an ability to identify businesses growing EPS faster than an average that does not exist, either objectively or subjectively. 'Value' implies that simple accounting ratios can mechanically rank-order stocks from cheap to expensive relative to their inherent worth. They cannot. To underscore the absence of real meaning and distinction in the terms 'growth' and 'value', as popularly applied, the S&P US Growth Index and the S&P US Value Index share the same largest holding – Apple.

We don't believe in the artificial distinction of *growth or value*. What we do believe in is **growth in value**. Growth in value occurs through companies earning superior returns on invested capital. We look to own those select businesses that become more valuable over time, where we can own them at less than today's value and where we judge the risk of disappointment to be low. Growth in value will be the topic of next quarter's Thought Piece.

Portfolio Changes

WATERS CORPORATION

We **purchased** a position in Waters Corporation (Waters) during the quarter. Founded in 1958 and based in Massachusetts, Waters is a leading scientific instrument testing company. Its instruments and consumables are used in the development of pharmaceutical and biopharmaceutical drugs, as well as in government and academic laboratories. Other important end markets are food safety testing and materials science.

Waters is a classic 'razor and razor blade' business model and 60% of revenue is derived from testing consumables and equipment servicing. The business produces very attractive growth and profitability. Return on invested capital is 35% and organic growth over the last decade has been around 7% p.a. Waters' capital structure is very conservative and it has net cash on the balance sheet.

Waters generated revenue in 2017 of US\$2.3b and has a market value of about US\$15b.

Stock Profiles

Below we discuss two IT businesses, Accenture and CDW. Both are growing revenue at around twice the rate of the overall IT market, and neither is a 'FANG' stock (Facebook, Amazon, Netflix or Google), or 'BAT' stock (Baidu, Alibaba, or Tencent). The common attractive features of these two companies are that they have both been around for more than three decades, both are the leaders in their respective markets and both are highly profitable.

ACCENTURE

*Accenture has deep, growing and durable relationships with the vast majority of the world's largest organisations. Key to this success has been Accenture remaining **relevant** and **competitive**.*

Accenture is the world's leading IT consulting and outsourcing company. It generated revenue of US\$35b last year, employs around 450,000 people and serves clients in 120 countries.

Accenture's size and scale brings with it some powerful competitive advantages. Its geographic breadth and expertise in 40 industry groups or 'verticals' has made it the IT outsourcing partner of choice for most of the world's largest organisations, including governments. Let's look at some numbers. Ninety-five of the Fortune 100 companies and three-quarters of the Fortune 500 are clients. One hundred and seventy-five companies spend more than US\$150m p.a. with Accenture, up from 138 four years ago. These 'Diamond Clients' include the likes of Disney, DowDuPont, Morgan Stanley and Pfizer. In the last quarter alone, Accenture signed 13 deals with a value above US\$100m.



Accenture has demonstrated success in attracting and retaining IT talent in a competitive marketplace. Its 5000 most senior executives have an average tenure of 15 years.

Accenture's client relationships have proved to be very durable – 98 of its 100 largest clients have been clients for more than 10 years. Key to these long-tenured relationships has been Accenture's emphasis on remaining *relevant* to its clients. As its clients' IT needs and strategic issues have evolved, so too have Accenture's capabilities. Ten years ago, implementing large SAP and Oracle enterprise software systems was a major part of Accenture's business. These remain important activities for Accenture, but management's mantra for a number of years has been 'rotate to the new'. Today, Accenture has very large operations in digital advertising, cloud, artificial intelligence (AI) and data security and these 'new' activities in total account for more than half the company's revenue. Accenture Interactive, its digital advertising group, employs 25,000 people and generated revenue last year of US\$6.5b, growing 35%. In data security, Accenture's revenue last year was US\$2b and is growing at three times the rate of growth of its market. It has more than 6000 patents and patent-pending applications in areas such as AI, cybersecurity and drones. In a survey, most of Accenture's clients believe it is the strongest firm to provide advice and strategy about AI and the adoption of big data solutions. Remaining *relevant* has been key to maintaining large, profitable, growing client relationships.

In addition to remaining relevant, Accenture must remain competitive. Key to this is labour efficiency, which in turn is a combination of minimising underutilisation as well as maximising the use of low-cost labour. Accenture has personnel located in 50 centres in low-cost countries around the world to provide cost efficiency in the back-end delivery. Accenture also makes intensive use of intelligent automation to remove low-value labour where possible.

Durable and long-tenured relationships apply internally as well as externally. Accenture's 5000 most senior executives have been with the company for an average of 15 years. It spent almost US\$1b in training and development in 2017.

Accenture has a long and successful track record of acquiring small businesses with specialist capabilities and growing them profitably. When Accenture acquired digital media company Fjord five years ago, it had 150 designers and five studios; it now has 1000 designers and 27 studios.

Over the last five years, Accenture's revenue has grown on an underlying basis at 7% p.a., around twice the rate of IT spending. In the three months to May, organic growth was 9%, including 17% growth in 'growth markets', which is primarily emerging markets. Accenture's growth continues to far outstrip the IT market, its major peers and the growth rate of the economies in which it operates. What's most important to management is profitable growth - its EBIT margin in 2017 was an impressive 15.2% - the highest for more than 15 years.

CDW

CDW is an IT reseller operating predominantly in the United States. In a business where scale confers significant advantages, its market share is equal to its nearest four competitors combined.

Founded in 1984 and originally named 'Computer Discount Warehouse', CDW is an IT reseller with revenue last year of US\$15b. Like Accenture, CDW is an IT services company focused on the corporate market and has also been growing consistently at a rate far in excess of total IT spending.

CDW can be thought of as a 'bridge' between IT companies like Microsoft, Cisco, HP Oracle and others, and their small to mid-sized corporate and government customers. IT hardware and software suppliers generally have salesforces that reach the largest organisations, say the Fortune 1000, but rely on resellers to reach the rest. Likewise, large organisations have internal IT departments with broad expertise and significant purchasing power in their own right. For companies below the size of the Fortune 1000, a reseller can provide a valuable role through its access to a broad range of suppliers, purchasing power and expertise. CDW's 'sweet spot' is public and private sector organisations with 5000-6000 employees. CDW represents 1000 IT OEMs and sells to 250,000 customers. For every supplier, CDW is their largest or second-largest reseller, so it is an important partner they are willing to invest in. If a product is in short supply, CDW will be near the front of the queue.

Although they are quite different businesses, CDW shares a number of Accenture's key competitive advantages - its scale, breadth and balance across end markets, and the fact that it is supplier-agnostic. This has led to similar outcomes: superior growth, long-tenured employees and an average customer relationship of 11 years.

In a very fragmented US IT reseller market, CDW has a share of 5%, equal to its next four competitors combined. Like Accenture, CDW is a company with a driven culture. Management's focus is on gaining market share, with the emphasis on profitable share. CDW's internal target is to grow 2-3% faster each year than the US IT market and it has achieved this objective for many years.

Salespeople are key to making CDW such a successful organisation. The relationship a customer has with CDW is first and foremost a relationship with an individual salesperson, so retention of the reps is integral to long-duration customer relationships. Good salespeople want to sell for CDW because of the breadth of offering and buying scale they bring, which in turn means the reps are well compensated. The average tenure of CDW's sales reps is 10 years.

Like Accenture, CDW is structured around a number of industry 'verticals'. This focus around a particular end market has proved very effective in growing share and is only possible because of CDW's scale. In 2014, CDW created a 'financials' vertical with dedicated sales teams aligned around three financial markets: banks and credit unions, capital markets and insurance. This follows on their success a few years ago with a US K-12 Education vertical. As CDW gets larger, it can create new 'verticals' and form groups with dedicated industry expertise.

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A COMMON SENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE

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