Selector High Conviction Equity Fund Quarterly Newsletter No.66

December 2019

In this quarterly edition, we review performance and attribution. Our lead article considers the singular focus that consumed Netflix on its path to becoming the world's leading subscription based online entertainment service. We follow this up with our interpretation of Geoffrey Moore's consulting work on how companies navigate the 'crisis of prioritisation', in our article titled “The Innovator's Dilemma”. We extend this further with our take on the Harvard Business Review’s top CEOs for 2019 in our piece “It starts at the top”. In our “Passage of Time” article we discuss the 'glue' that is time and how it relates to complementary medicines group Blackmores. We also discuss our thoughts on the thorny issue of proxy advisors. We review Oil Search following our recent company led investor tour to the company’s Papua New Guinea operations and finish with a book review on, The man who solved the market.

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Selector is a Sydney based fund manager. Our team combines deep experience in financial markets with diversity of background and thought. We believe in long-term wealth creation and building lasting relationships with our investors.

We focus on stock selection, the funds are high conviction, concentrated and index unaware. As a result, the portfolios have low turnover and produce tax effective returns.

Selector has a 15-year track record of outperformance and we continue to seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management.

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IN BRIEF – DECEMBER QUARTER

Dear Investor,

The financial scoreboard would show that the local share market delivered a positive last quarter for 2019 to cap off an even better full year performance. It is hard to imagine that in a year gripped with so many dislocating events, be it the ongoing trade wars, Brexit or geopolitical fallouts, that a positive double-digit calendar year gain of 19% for the All Ordinaries Index would even be remotely considered possible.

Circumstances including the unprecedented decline in global interest rate settings certainly played its part, along with benign inflationary outcomes. Plenty continue to call the market as being late in the economic cycle, giving rise to general investor caution and greater allocation to more defensive assets, including cash.

To that end an economic recession is an outcome that many still expect, driven by weak global growth. On the surface it is hard to argue that a slowing global economy won't inflict some pain, perhaps even a great deal of pain. However, resolution to a number of economic roadblocks is likely to unleash broader business confidence. Under this scenario a more positive outlook should emerge.

We are unclear how things will play out, noting that it has little influence on how we invest. What we will mention though is the role technology continues to play, both as an enabler and disruptor, by driving structural changes and marginalising businesses that are caught behind the investment curve. Now more than ever, businesses need to harness all the necessary skills in striving for market or product leadership. Leadership matters because scale provides scope for ongoing reinvestment, creating stronger business barriers. Over the long run, the positive latency that a business with focus, scale and market leadership enjoys is only likely to grow.

In this quarterly we expand on these themes. Looking through the lens of Netflix, our opening article considers the singular focus that consumed the company on its path to becoming the world's leading subscription based online entertainment service. This is followed with "The Innovator's dilemma", our interpretation of Geoffrey Moore's consulting work looking at how companies navigate the *"crisis of prioritisation"*. We extend this further with our take on the Harvard Business Review on the top CEOs for 2019 in our "It starts at the top" piece.

We then go on to discuss the "Passage of time" and how this relates to complementary medicines group Blackmores. We explore the thorny issue of proxy advisors, and more specifically their growing power base in directing voting outcomes at annual general meetings and the potential consequences this has.

We revisit Oil Search following our recent company led investor tour to the company's Papua New Guinea operations. Finally, we provide our input into our latest book review, *The man who solved the market*.

For the December quarter, the Fund delivered a gross positive return of **2.63%** compared to the All Ordinaries Accumulation Index which posted a gain of **0.75%**. For the 2019 calendar year, the Fund has delivered a gross positive return of **39.28%** compared to the Index which posted a gain of **24.06%.**

During the quarter, the Fund achieved a milestone by marking 15 years since inception. Over this period, the Fund recorded a gross compound annual return of **14.05%** compared to the All Ordinaries Accumulation Index which posted a yearly gain of **8.44%**. We are particularly proud of this achievement as it reflects the longevity of our investment approach.

We trust you find the report informative.

Regards,

Selector Investment Team

Microsoft is the world's most valuable listed company valued at over US$1 trillion. Its CEO Satya Nadella reflects on lessons learnt, having joined the company in 1992, and as CEO since 2014.

"I think that companies are born with a sense of purpose...I believe we have identities as companies like human beings, and I want us to stay true to that. I want us to be proud of being that company that creates technology so that others can create more technology."

For Microsoft, the leadership of Nadella cannot be understated. As CEO Nadella identified, *"companies are born with a sense of purpose"* and having returned to its core expertise in enterprise technology, the business has thrived.

The shift to cloud computing is now driving the company and Nadella makes no apologies that this is fundamental to its future success. *"Mobile devices come and go, but the one thing that won't go away is the broad computing fabric that stitches all this together."* Nadella refers to the cloud as *"the world's computer"*.

Satya Nadella
CEO of Microsoft

PORTFOLIO OVERVIEW

Table 1: Performance as at 31 December 2019*

	3 Month	6 Month	1 Year	3 Year	5 Year	10 Year	15 year	Since Inception
Fund (net of fees)	1.55	7.65	35.32	20.47	16.94	13.27	11.52	11.75
Fund (gross of fees)	2.63	9.88	39.28	23.06	19.29	15.48	13.69	13.93
All Ords. Acc. Index	0.75	3.59	24.06	10.41	9.30	7.86	7.98	8.42
Difference (gross of fees)	1.88	6.29	15.22	12.65	9.99	7.62	5.71	5.51

Inception Date: 30/10/2004

**Performance figures are historical percentages. Returns are annualised and assume the reinvestment of all distributions.*

Graph 1: Gross value of $100,000 invested since inception

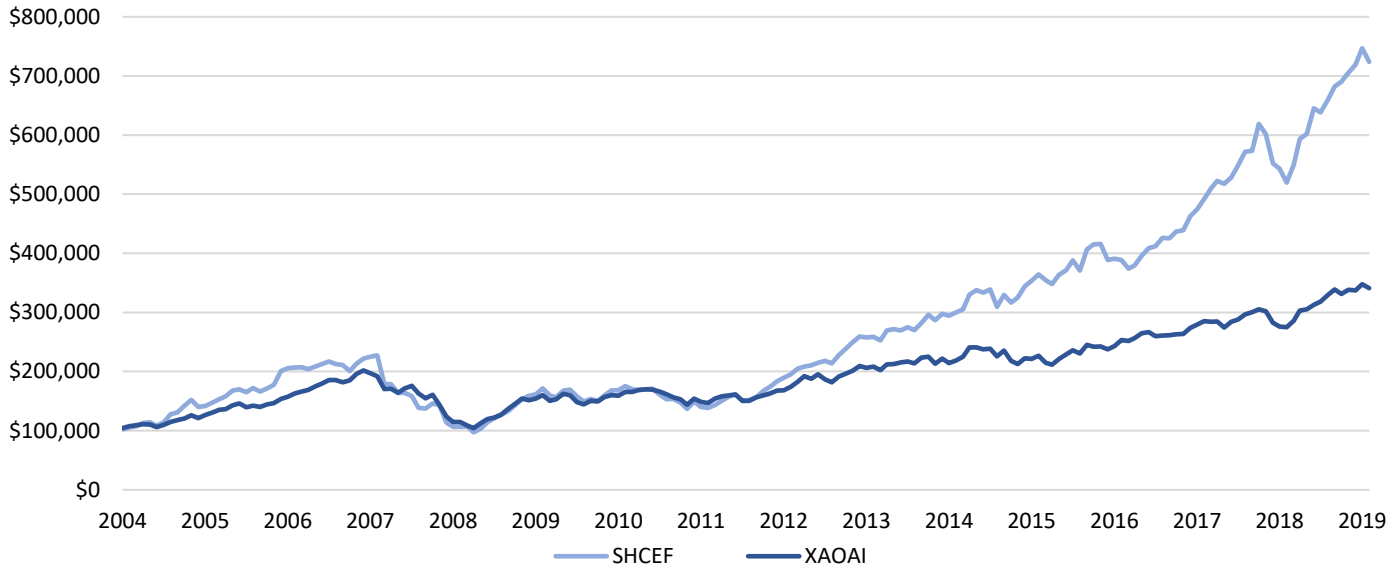


Table 2: Fund's Top 10 Holdings

Top 10 December 2019	%	Top 10 September 2019	%
Aristocrat Leisure	6.33	Aristocrat Leisure	5.97
James Hardie Industries	5.22	Jumbo Interactive	5.90
Altium	5.01	Altium	5.00
Seek	4.99	Flight Centre Travel Group	4.98
ResMed	4.86	Seek	4.93
Cochlear	4.59	James Hardie Industries	4.83
Infomedia	4.47	ResMed	4.57
Flight Centre Travel Group	4.44	Infomedia	4.50
Nanosonics	4.32	Nanosonics	4.45
CSL	3.88	Cochlear	4.41
Total	**48.11**	**Total**	**49.54**

Table 3: Unit prices as at 31 December 2019

Unit Prices	Entry Price	Mid Price	Exit Price
	$3.1178	$3.1100	$3.1022

Selector employs a high conviction, index unaware, stock selection investment strategy. The Fund's top 10 positions usually represent a high percentage of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average "*run-of-the-mill index hugging*" fund manager. Our goal remains focused on truly differentiated broad-cap businesses rather than the closet index hugging portfolios offered by most large fund managers.

Table 4: ASX sector performance – December 2019 quarter

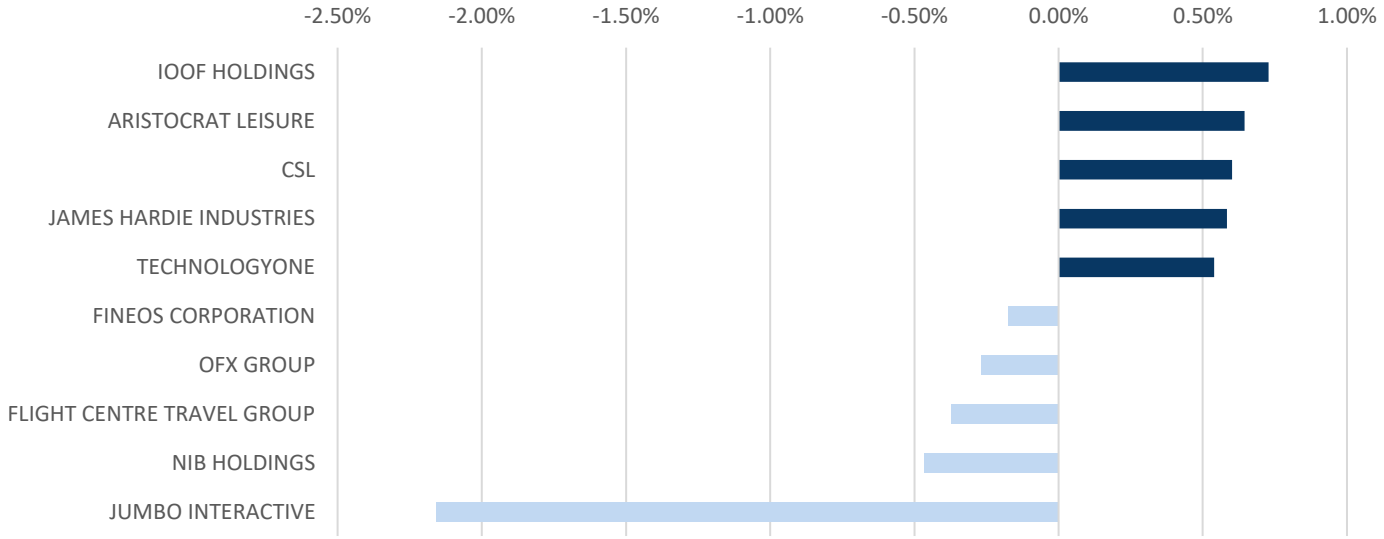
S&P ASX Industry Sectors	Quarter Performance (%)
Healthcare	13.97
Energy	6.28
Materials	4.13
Industrials	3.10
Consumer Discretionary	2.76
Information Technology	1.65
Utilities	0.49
Telecommunications	(0.25)
A-REITS	(2.60)
Consumer Staples	(2.72)
Financials	(7.76)

Table 5: Fund's industry weightings

Industry group	December 2019 (%)	September 2019 (%)
Software & Services	21.52	20.96
Consumer Services	20.34	22.57
Health Care Equipment & Services	16.26	15.63
Materials	7.13	6.76
Capital Goods	6.20	6.27
Diversified Financials	5.93	5.68
Commercial & Professional Services	4.99	4.93
Pharmaceuticals, Biotech & Life Sciences	3.88	3.41
Energy	2.92	3.06
Household & Personal Products	2.88	3.02
Insurance	2.84	3.43
Media & Entertainment	2.39	2.28
Automobiles & Components	1.27	N/A
Cash & Other	0.77	1.34
Consumer Durables & Apparel	0.68	0.65

PORTFOLIO CONTRIBUTORS

Graph 2: Contributors and Detractors – December 2019 quarter



Top quarterly contributors

1. IOOF Holdings (ASX:IFL)

The ANZ Banking Group and OnePath Custodians provided clearance for the transfer of the ANZ Wealth Pension and Investments (ANZ P&I) business to IOOF, which was first agreed and announced in 2017. Post the Royal Commission into the Banking, Superannuation and Financial Services Industry, the sale was delayed pending approval from the Trustees and final sign-off from Australian Prudential Regulation Authority (APRA).

With IOOF clearing two major hurdles – successfully defending itself against APRA's legal action in September, and getting final APRA approval in December for the sale and transfer, after an extended period of review – this decision seemed the only logical conclusion for current owners, ANZ.

The decision means IOOF is acquiring this business for $825m, a $125m drop in the sale price first announced to the market in October 2019. Along with the loss-making Aligned Dealer Group (ADG) also acquired from ANZ, the total consideration totalled $850m.

This combined business is set to deliver a net profit contribution of circa $66m; $91m of profit coming from the ANZ advice business and the expected $25m loss driven by the ADG. The ANZ P&I business concluded the September year end with $48.4b of funds under management. This amount will flow to the IOOF group once the deal is finalised, with an expected completion date of 31 January 2020.

Post the settlement of this purchase and taking into account recent business sales, including Ord Minnett, IOOF's net debt is estimated at circa $250m.

IOOF has a current market capitalisation of $2.9b.

2. Aristocrat Leisure (ASX:ALL)

Leading global gaming operator Aristocrat Leisure maintained its impressive financial performance, delivering a high quality full year result ending September 2019. Now into his second year as group CEO, Trevor Croker continues to shape the company's strategic direction, encompassing both land-based and digital gaming operations.

From its dominant market leading position, Australia continues to provide a strong and a highly recurring level of cash flow. For the year, local operations delivered $455m of sales and operating profits of $213m, resulting in solid margins of 47%.

Attention however is clearly focused on the U.S. operations, which have lifted to a higher level following recent significant operational expansion and acquisition activities. Split into two distinct markets, land-based and digital, each are providing scope for long-term growth.

In the land-based sale and placement of gaming machines, Aristocrat is the leading player in several key

market segments. Overall, the traditional land-based operations lifted sales 14% to US$1.4b, delivering operating profits of US$751m and margins of 55%. The group sold over 17,000 new gaming units during the year and deployed a total of 48,000 participation units in the field, yielding US$50 per machine per day.

In digital, management continues to bed down recent acquisitions, comprising Big Fish and Plarium. As such, the 2019 year has been described by management as one of transition. The group continues to refine its learnings around the digital portfolio, having lifted online bookings 6% to US$1.2b, with segment profits remaining relatively flat on a comparable basis at US$370m.

In total, revenues rose 23% to $4.4b, while net profits before amortisation also lifted 23% to $894m. Dividends were raised 22% to 56 cents per share for the full year, while the group's payout ratio of 40% remains at conservative levels. Strong free cashflow of $748m, following significant R&D expenditure totalling $500m, and combined marketing and capital expenditure outlays of some $800m, underscores the group's powerful financial position.

This becomes more evident when reviewing key metrics, such as return on capital employed and net profit margins, which at 31% and 20% respectively are market leading. Net debt coverage at 1.4x continues to improve, down from 1.7x a year earlier.

With over 65% of earnings recurring in nature, management has the capacity to invest over a longer time horizon. This is giving rise to consistent investment in the areas of product content, distribution capabilities and personnel talent.

The business is in a strong position, with clearly defined growth opportunities and operating at scale. While no formal earnings outlook was provided, the key U.S. market segment is set for stronger growth during the year, underpinned by operational efficiency benefits and a materially lower corporate tax rate.

Aristocrat Leisure has a current market capitalisation of $22.6b, with net debt of $2.2b.

3. CSL (ASX:CSL)

Global plasma leader CSL continues to deliver impressive product portfolio performance and operational excellence. The business delivered year-on-year growth in revenues and net profits of US$8.7b and US$2.0b, up 11% and 17% respectively.

The CSL Behring division, which houses the key therapy products of Immunoglobulins, Albumin, Haemophilia and Specialty, collectively grew 10% to US$7.3b, with operating profits of US$2.3b.

The division's diversified product portfolio comprising of long-established therapies, including Privigen and Hizentra, are being well supported by newly released products. This includes Idelvion, up 40%, and Haegarda, which grew 61% over the period. Management, led by CEO Paul Perreault, remain extremely confident of the ongoing market demand, despite supply setbacks including albumin transition issues in the China market and competitive product responses.

This is reflected in the group's ongoing commitment across three main areas:

1. Plasma collection centres

The company's collection network continues to be the main source of plasma supply and a key competitive advantage. CSL is the market leader in sourcing plasma, operating 221 centres in the U.S. alone, with 30 new centres opened in the U.S. during 2019 and an additional 40 earmarked for 2020. The group operates a further 16 centres in the offshore markets of Germany, Hungary and China.

2. Capital expenditure

Therapy innovation is reflected in the company's significant investment in research and development (R&D). During 2019, the company lifted this by US$150m to US$832m. This investment is fully expensed and represents 9.7% of group revenues.

Investment in capital projects, including new global manufacturing capacity and ongoing collection centre openings, topped US$1.2b. The majority of the spend is earmarked for new growth initiatives.

3. Seqirus – Flu business

The company's flu vaccine business, Seqirus continues to hit critical operational milestones. For the year, revenues rose 12% to US$1.2b, while operating profits saw a strong uplift from US$52m to US$154m. Management confirmed the business remains on track to hit operating margins of 20%, as per the original business plan on acquisition, up from 12.8% in 2019.

The business delivered earnings per share of US$4.23 (A$6.13) and paid out full year dividends totalling US$1.85 (A$2.68).

The company provided a positive outlook for 2020, with net profits expected to rise 7-10%, within a range of US$2.05b to US$2.11b.

CSL has a current market capitalisation of A$136b and net debt of US$4b.

4. James Hardie Industries (ASX:JHX)

Leading fibre cement producer James Hardie achieved a strong second quarter and half year performance, delivering on CEO Jack Truong's long-term positioning of the business. Operating in three geographical regions, including North America, Europe and Asia Pacific, the group's priorities are translating into strong financial outcomes.

At its core is a focus on driving above market growth, achieved by sustaining operational performance across the group's extensive manufacturing operations. This is backed up with product innovation and underpinned by a culture of clear employee alignment and operational accountability.

The latest set of numbers clearly illustrate the significant progress made to date. Focusing specifically on the quarter ending September 2019, the key operating metrics across all three regions were positive. This is reflected in higher group net sales up 2% to US$660m, gross profits rising 16% to US$240m and adjusted operating profits increasing 22% to US$134m.

For the half year the company lifted net sales 2% to US$1,317m, with net profits up 17% to US$189m. Most impressive has been the lift in operating performance in the key U.S. market. A reset on the company's go-to market strategy here is beginning to pay dividends. The business is now engaging with both the builders (creating pull demand) and distributors (push demand) in its pursuit of growing the exteriors business above market. This is partly reflected in management lifting full year guidance on primary demand growth (PDG) from 3%-5% to 4%-6%.

Lean manufacturing is tracking ahead of expectations, with management attributing 50% of the four percent gross margin improvement to this pursuit. Pleasingly, U.S. quarterly profits of US$125m reached a record, as did operating margins of 27.1%. The group is now lifting U.S. margin guidance within the range of 25%-27%, compared to previous estimates of 20%-25%.

In Asia Pacific the company is taking share in an overall tougher market as Australian volumes decline, offset by growth in the Philippines. In Europe, the business is in the early phases of driving fibre cement growth, complementing the company's existing fibre gypsum operations. For the full year ending March 2020, the company is on track to record growth in sales and higher operating margins.

Management have also lifted the company's net profit guidance for the full year to sit within the range of US$340m-US$370m. Half year dividends were maintained at US10.0 cents per share.

James Hardie has a current market capitalisation of $13.1b.

5. TechnologyOne (ASX:TNE)

Leading enterprise Software-as-a-Service (SaaS) provider TechnologyOne reported its full year 2019 result during the December quarter. For the year, the group recorded total revenues of $286m, up 13% and operating profit before tax of $76m, up 50% on a comparable basis.

Strong operational efficiencies have been realised as the company continues to migrate enterprise customers to their SaaS offering, with the profit before tax margin increasing from 20% to 27% over the period. The company’s SaaS product is compelling for customers as they can access the entire suite of products immediately, without having to manage any internal infrastructure. TechnologyOne now has 435 enterprise customers using this platform, up 25% from the 347 reported for the prior corresponding period. This has led to a 44% lift in the SaaS Annual Recurring Revenue (ARR), equivalent to $102m, over the course of the year.

The company is still aiming to hit its target of 1,000 enterprise customers on the SaaS platform by 2022, with expected ARR of over $500m forecast in FY24. Over 80% of TechnologyOne's revenue is recurring in nature, supported by a strong customer retention rate exceeding 99%.

With the company transitioning to a SaaS offering, it’s worth noting that the portion of R&D investment spend, deemed longer-term in nature, is no longer fully

expensed. Rather, some of these costs are now capitalised, held on the balance sheet as an asset and depreciated over time. While this treatment of costs is not as conservative as past practices, it is in line with accepted accounting standards and comparable to how development investments are treated within other SaaS businesses.

The group maintains a conservative approach to capital management with cash growing and the dividend payout ratio maintained at 65%.

TechnologyOne has a current market capitalisation of $2.9b, cash of $105m and no debt.

Bottom quarterly contributors

1. Jumbo Interactive (ASX:JIN)

Leading internet lottery operator Jumbo Interactive provided a first half trading update for 2020, guiding to a rise of 27% to $188m of Total Transaction Value (TTV) processed through the platform. This is expected to result in forecast revenues of $37.8m and a net profit after tax of $14.3m, an increase of 27% and 13% respectively for the half. Despite the relative strength of this performance, the guidance fell short of market expectations.

The continuing shift from the traditional offline retail setting to online lottery play, particularly for younger demographics, continues to present an ongoing long-term opportunity for the company. In any given period however, the level of TTV growth achieved remains largely dependant on large jackpot activity, which is by nature unpredictable.

Jumbo's recently rolled out software, *"Powered by Jumbo"* is not expected to drive a material revenue contribution over the first half 2020. However, the company is expecting this to be an important driver of future revenue as the business continues to scale. Since November 2018, *"Powered by Jumbo"* have confirmed the signing of three customers, its most recent being charity lottery operator Deaf Services. At this point management is looking to add at least two new customers per year to the platform.

The company also expects the recent acquisition of U.K. based Gatherwell to provide a positive contribution in the current financial year. Gatherwell currently services around 80 local authorities and 1,000 schools, facilitating the sale of roughly 130,000 tickets per week. Gatherwell is forecast to generate circa £7.6 million in ticket sales, circa £1.5 million in revenues and circa £0.4 million of net profit before tax for the period to June 2020.

While the company may have not met market expectations for the current year, management has taken the opportunity to increase its level of business investment. This has included higher marketing spend, whilst incurring additional costs associated with the increase in corporate activity. Management is taking a sensible long-term approach, which comes at the expense of short-term profits.

Jumbo has a current market capitalisation of $983m, with cash of $84.6m.

2. NIB Holdings (ASX:NHF)

While market commentators point to Medibank Private as an example of a business pivoting to remain relevant, few have acknowledged the work undertaken at rival healthcare insurer NIB Holdings. Under the leadership of CEO Mark Fitzgibbon, NIB has delivered for both owners and customers, evolving new lines of business that are focused squarely on the healthcare segment.

As a group, underlying revenue increased 8.3% to $2,421.6m, with underlying operating profit (UOP) increasing 9.2% to $201.8m. While Australian Residents Health Insurance (ARHI) remains the dominant profit contributor, delivering $150m of the total UOP, the opportunity set residing in all business segments is substantial. CEO Fitzgibbon is unashamedly positive in providing better health solutions and customer outcomes. Personalised healthcare will become a key enabler, while the need for healthcare cost transparency will dictate greater customer engagement.

Today, NIB provides health insurance cover to over 889,000 policyholders, comprising more than 1.1m individuals. This encompasses traditional health cover in Australia, as well as student and worker's insurance housed in the group's International business segment and New Zealand. In NIB travel, the segment of the business that CEO Fitzgibbon calls out as having the greatest long-term upside, over 730,000 policyholder sales were completed during 2019, split evenly across a domestic and international customer base.

As an important and leading indicator of customer satisfaction and relevancy, Net Promoter Scores (NPS) also continues to point in the right direction. These

results are published in the company's Sustainability Report and explained in our August 2019 Quarterly Newsletter article, *"The NPS Culture"*. Amidst a flurry of media reporting that continues to lambast the health insurance industry, the numbers are impressive. They also reinforce the need for health insurance providers, with over 40% of all Australian hospital admissions and 60% of all elective surgeries funded by the private insurance sector in 2019.

For 2020, management is guiding to a similar profit outcome to that achieved in 2019. This is as much a reflection of the strong growth achieved during 2019 and the conservatism that underpins management's approach. The group continues to fly under the radar of most investors despite a track record that would demand otherwise.

In December the group also announced the resignation of CFO and Deputy CEO Michelle McPherson, following her appointment to another CFO role with a publicly listed company. CEO Fitzgibbon noted the significant contribution made by McPherson during her 16-year tenure with the business, *"Michelle is an expert in her field of finance, highly intelligent, incredibly hard working, widely respected and a friend. She will be very much missed by us but we wish her every success."*

NIB has a market capitalisation of $2.9b and a 9% market share of the Australian health insurance sector.

3. Flight Centre Travel Group (ASX:FLT)

Travel operator Flight Centre Travel Group updated shareholders at the company's November annual general meeting. Following a soft first quarter performance, primarily as a result of the group's Australian leisure business and other segment activities, the company is forecasting a weak first half operating profit range of $90-$110m. This compares to the 2019 first half operating profit of $140m. For the full year the guidance range is $310m-$350m, in comparison to the $343m delivered in the prior period. At the mid-point of the new profit range, this would represent a 4% decrease from the 2019 result.

While these numbers reflect a tougher consumer environment, the underlying group segments provide greater transparency into key areas of the business. The company continues to generate healthy top-line growth in Total Transaction Value (TTV), up 11.4% globally for the first quarter.

In Leisure, Australian operations continue to transition. While gross margins have improved, stronger Total Transaction Value (TTV) growth is required to offset lower margin revenue business lines, encompassing online travel and foreign exchange. Overall, TTV leisure rose 4.5% globally for the first quarter.

In Corporate travel, the company continues to enjoy strong growth with the group recording first quarter TTV up 18%. This is underpinned by the America's market, up 28% and EMEA up 36% (supported by acquisitions) for the period. CEO Graham Turner noted the group is on track to record Corporate TTV of $10b for 2020, representing over 40% of overall group TTV.

Importantly, the U.S. corporate business surpassed the Australian corporate business during the first quarter, illustrating the future potential of a market that is 30-40 times larger. Similar expectations are held for the EMEA business and on a broader measure the Asia region is delivering strong top-line growth.

The company is investing heavily in new technologies and systems, with some 50% of the company's annual $100m capital expenditure budget earmarked in these areas.

As previously noted, the group continues towards its 2022 transformation goals of:

1. Growing TTV by 7% per annum
2. Maintaining cost margin below 10%
3. Returning to a 2% net profit margin

CEO Turner noted, *"We don't feel that a change to these goals is currently needed, as we continue on a business engineering and investment phase, although we accept that our Australian leisure business will take longer to recover than initially anticipated".*

Flight Centre Travel Group has a current market capitalisation of $4.5b.

4. OFX Group (ASX:OFX)

In November global international payment services supplier, OFX Group announced its first half result for the 2020 year. On the back of strong momentum in North America and Corporate segments, revenue over the half increased 0.5% to $65.3m, with operating profits

(underlying EBITDA) increasing 2.3% to $16.5m despite a difficult trading environment.

While the business has historically catered to the consumer segment, a deliberate shift to servicing corporate clients is impacting the number of active clients, which declined 3% from the prior corresponding period to 154,000. This segment also felt the full impact of current global uncertainty, leading to lower business transaction activities. This is reflected in a 9.3% decrease in the Average Transaction Value (ATV) to $21,100 and resulted in a 5% drop in total turnover to $11.5b for the period. The company expects this to reverse as confidence returns to the market.

In relation to OFX's ongoing focus, the business priorities remain unchanged. CEO Skander Malcolm commented *"As we execute in the second half, our growth priorities are clear. We will continue to develop our regional growth strategy, particularly in North America, while improving the client experience, growing our Corporate and Enterprise base, and building partnerships to help us grow and execute more effectively. This while maintaining our key financial commitments of delivering annual positive operating leverage on an underlying EBITDA basis and stable Net Operating Income margins."*

OFX has a current market capitalisation of $340m and no debt.

5. Fineos Corporation (ASX:FCL)

The company recently released its September Quarterly in which they announced the appointment of David Hollander, a U.S. based Non-Executive Director, to the group's board. Hollander comes with extensive experience in the insurance industry and will also take on a consulting role for the company.

In December, Fineos provided a trading update which confirmed an increased revenue forecast between €80-€82m, up 8-11% from the prospectus forecast of €74m. This growth has been largely driven by increased client engagement and demand for Professional Services.

CEO & Founder Michael Kelly commented, *"At 5 months into the financial year, we are very pleased with the momentum of the business, which has led to this upgrade in revenue growth beyond our initial forecasts. This growth is due to increased client engagement and the accelerated demand for the implementation of our FINEOS Platform for Claims and Absence management (IDAM) software from our U.S. Employee Benefits clients."*

Fineos has a market capitalisation of $695m, with no debt.

COMPETITION LEADS TO FOCUS

"As a start-up, it's hard enough to get a single thing right, much less a whole bunch of things."

Marc Randolph, Co-founder and CEO of Netflix

The latest book to hit our office library collection is one written by Marc Randolph, co-founder and first CEO of the original online movie house, Netflix. Randolph titled the Netflix story, *That will never work*, reflecting the naysayers who ridiculed the idea and the dedication of its founding team to prove them wrong.

More than 20 years on since the concept of renting movies online first took hold in 1997, Netflix has evolved into the successful business that it is today. In his book, Randolph plots the path from idea to setbacks, through to funding and all the subsequent twists and turns that come with starting a business.

The driving force behind the Netflix business was a burning desire to sell something on the internet. These were the hallmarks of the first dot-com boom and Amazon, led by its founder Jeff Bezos, had just begun selling books online. For Randolph, avoiding physical video stores and ordering movies online, followed by direct shipment to the customer, seemed like a no-brainer.

In reality it was far more challenging than that. The logistics of customers ordering online and getting product shipped and delivered in a timely manner, without product damage, and done at a cost that wasn't prohibitive, proved difficult to execute. Secondly and unintentionally, Netflix chose to take on the behemoth in the industry, Blockbuster.

As Randolph wrote, *"Blockbuster had been the brainchild of Wayne Huizenga, who in the late 1980's saw an opportunity to roll up the still mostly mom-and-pop video stores that dotted the country. Rapid expansion in the 1990's – at one point, the company was opening up one new store every day – had given them a near monopoly on video rental and had made them one of the most ubiquitous brands in the country. They were the king of the world in 2000, but we had no idea if they even knew who we were. Or if they cared.*

As big a deal as we were online, we did a fraction of the business they did. We were on track to do $5m in revenue in 2000 – Blockbuster were aiming for $6b. We had 350 employees – they had 60,000. We have a two-story HQ in an office park in Los Gatos – they had 9,000 stores. They were Goliath. We were David. But we knew e-commerce was the future".

And as the saying goes, the rest is history. Blockbuster failed to adapt and went bust, closing down all their remaining U.S. corporate stores in 2013-14. In contrast, Netflix is currently valued at US$148b, and is on track to record revenues of circa US$20b with operating profits of US$2.5b.

The aim of this article is not to dissect the history of Netflix but instead to narrow down on one point, the importance of focus. It was 1998, Netflix was off and running, but not making money. Others were interested in what was on offer. Amazon approached with a business plan, which Netflix politely declined.

While the company sold plenty of DVDs, it wasn't enough to cover the costs of running the business. The lack of a scalable, repeatable and profitable business model led to an unlikely outcome. Randolph and partner Reed Hastings agreed to abandon the only profitable part of the business, the sale of DVDs, to turn their attention towards DVD rentals. It required an understanding that in order to prosper, something had to give, *"Kinda put all your eggs into one basket. That's the only way to make sure you don't break any".*

It is a point worth reinforcing, best done by Randolph, *"One of the key lessons I learned at Netflix was the necessity not only of creative ideation, or of having the right people around you, but on focus. As a start-up, it's hard enough to get a single thing right, much less a whole bunch of things. Especially if the things you are trying to do are not only dissimilar but actively impede each other. Focus is imperative. Even when the thing you're focusing on seems impossible. Especially then".*

In the years that followed, this decision became even more significant. Up until then, funding to keep Netflix afloat had been provided by multiple parties. Initially by Hastings, who had invested US$2 million for a 70% shareholding interest, and then later by venture

capitalists investing in excess of US$100m, with a valuation of circa US$10 per share.

Post the Nasdaq Composite Index peak in 2000, share price valuations for technology companies and internet start-ups collapsed. External funding that was readily prepared to invest prior to the market's fall, all but dried up.

For Netflix this was its moment of truth. While its subscription movie rental business was gaining traction, it was still haemorrhaging some US$50m per annum. It could no longer rely on external investors to provide new funding. A different solution was required, and it came in the form of what Randolph termed *"The Canadian Principle".*

Before the share market collapse, Canada was the obvious market for expansion, due to its proximity and offering good upside. Netflix calculated that expanding into Canada would give the group an instant 10% kick to revenues.

Despite this, the company chose not to act. The reasoning speaks volumes of why Netflix went on to achieve greater success. The founders deemed that while the upside was clear, two factors worked against the move. The first was that no matter how obvious the advantages, differences around currency and language used in some parts of the country would prove more complicated than it seemed at face value.

The bigger reason for staying put however, was even simpler. Shifting the intellectual effort and manpower required to enter a new market, to the group's existing business instead, would eventually generate a far greater return than 10%.

"Expanding into Canada would have been a short-term move, with short-term benefits. It would have diluted our focus."

This same long-term mindset led to management's realisation, that in order to become profitable they needed to make some tough decisions. The business was on track, but the funding runway was now short. While a near term target of 500,000 subscribers was pleasing, a number closer to two million was needed.

Jobs had to go and, in the end, some 40% of the company's 350 employee base were released. As painful as the process was, it worked to create a renewed commitment within the firm.

Randolph reflects on this moment in the book, *"In the weeks and months following September's painful lay-off, we started to notice something. We were better. More efficient. More creative. More decisive. Winnowing our staff made us leaner and more focused. We no longer had time to waste, so we didn't waste it…You see this often in successful start-ups. The business gets off the ground because of the focus, dedication and creativity of a small group of dedicated people. It grows, hires big – and then contracts itself. It rededicates itself to its mission – and often accomplishes it through the renewed focus and energy of the most valuable newer members."*

We are no experts on the Netflix business or what its future may hold. What is apparent though, is a company that has been disciplined in its approach, with a core customer following and a successful global expansion to supports it. Reed Hastings continues to steer the company as CEO with new challenges ahead, largely in the form of deep pocketed competitors like Disney.

Our focus here is not on how a start-up made it big, because in actual fact there are many that never get past first base. Instead it's how a company and its two founders, Randolph and Hastings, were able to channel all their collective efforts into an idea that no one believed would work.

Perhaps it is a reflection of founders who push through and are prepared to tinker and chip away in defiance of the crowd. More broadly though it demonstrates the importance of sticking to a core outcome, one that resonates throughout the entire culture of an organisation.

Herein lies our point. Companies, no matter whether big, small, start-up or established, all need to lead with a purpose that is devoid of unnecessary distractions. As Randolph remarks, their success was largely based on removing albatrosses from the business by this ruthless streamlining, *"scrapping the barnacles off the hull"*. In short, it is a constant pursuit of knowing where you are going and remaining vigilant to that cause.

It is something that we have adhered to at Selector since inception back in 2003. We have only one investment philosophy, applied across all our portfolio accounts. Ours is a long only, index agnostic, bottom-up business

selection process. We don't use derivatives, nor do we hedge or borrow, and we don't short. It's a very clear, well-articulated and focused investment approach.

Importantly, we know what it means when share markets drop sharply, as we have no place to hide. We are not actively seeking protection when we invest because we understand we are putting capital at risk.

The reason for outlining this is to remind and educate our investors that investing is a risk-on activity.

We aim to deliver positive returns over the long-term but no amount of shorting or hedging or any other mechanism protects from capital loss at points in time.

The Netflix approach to remain ruthlessly focused, is an attribute we similarly seek in any business investment we consider. There are many in our portfolio that come to mind, including James Hardie Industries[1], Nearmap[2] and Nanosonics[3] to name a few. We have laid out the reasons for our confidence in each of these businesses in past editions of our quarterly newsletter, but a few comments here may help to distil this point further.

Since 2005, under the previous leadership of CEO Louis Gries, James Hardie set out a very simple, ambitious U.S. game plan. From a zero market share standing start, Gries' single strategic goal was focused on growing and capturing market share in the U.S. siding (cladding) market.

The company described this as its 35:90 strategy, with the long-term aim of fibre cement products controlling 35% of the U.S. housing market for both external and internal use. Of fibre cement, the group's objective was, and continues to be on capturing a 90% market share. In short, it embarked on controlling the lion's share of a new product segment in home siding, by displacing the incumbent vinyl and wood type products.

The financial score card would show the success of the strategy Gries unveiled and pursued, resulting in the world's leading fibre cement business. However, in recent years, a series of distractions and succession planning missteps eroded confidence. Put simply, the business had not kept pace with its own success.

Enter new CEO Jack Truong, an outsider with significant international experience. In the short time since his appointment, Truong has re-stated the core priorities with a singular focus of, *"transforming from a big, small company to a small, big company".* He has, in our opinion, succeeded in unifying the team, with a winning game plan.

At Nearmap, the business is in many ways a mini version of Netflix in its formative years. The company is growing strongly, but not yet profitable. Management have set very high expectations to be the leading geospatial image capture business globally, with its unique technology and service offering.

The management team is fully engaged and there is a clear line of sight of what success looks like. There are no distractions and the company is absolute in this pursuit.

With equally big aspirational goals, but perhaps further advanced than Nearmap, is Nanosonics. The company has assembled an impressive team of high achievers backed by a founder-led board. There is alignment, focus, funding and commitment to changing medical practice in the infection prevention market.

Having successfully delivered a global solution for high level disinfection of all semi-critical ultrasound probes, the group is unashamedly working to the bigger goal.

Companies like Netflix and those listed above in our portfolio all share a common thread. They are in pursuit of an end goal, with clearly defined targets and performance metrics. Their leaders are motivated and engaged, accompanied by a winning executive team culture.

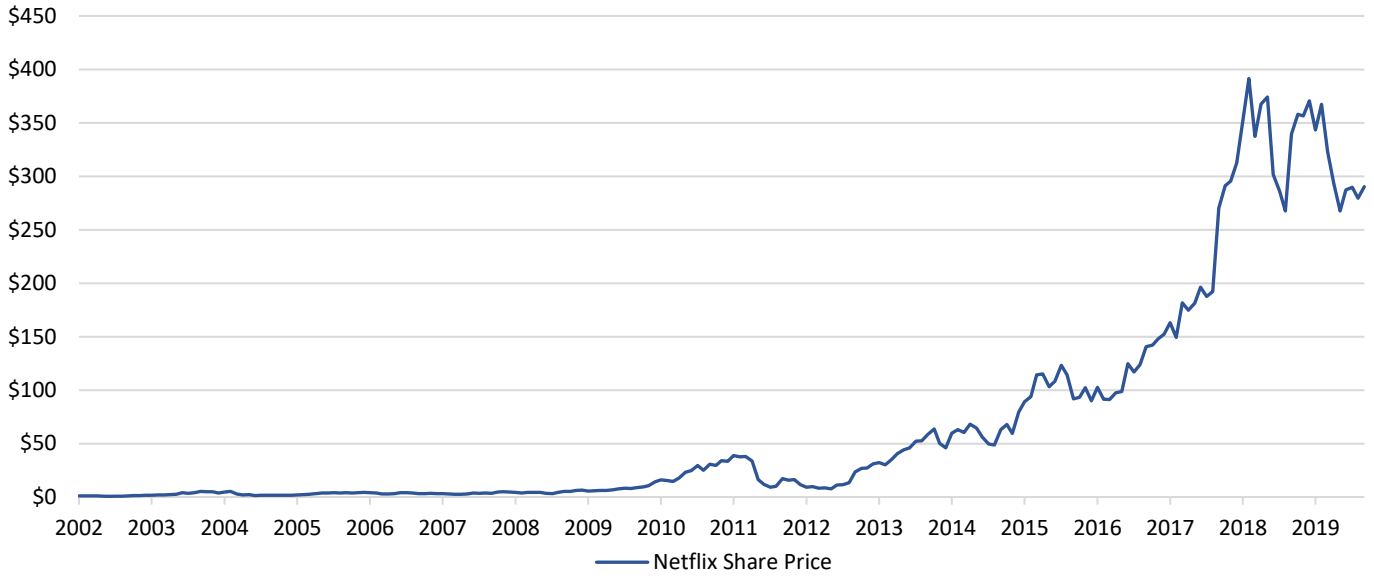
All up this won't guarantee success but it's a damn good start and one we are more than prepared to back. ***SFM***

[1] *"James Hardie Industries – Succession", SFML March 2019 Quarterly Newsletter*

[2] *"Nearmap – Changing the way people view the world", SFML December 2018 Quarterly Newsletter*

[3] *"Nanosonics", SFML June 2018 Quarterly Newsletter*

Chart 1: Netflix Share Price since inception



Source: IRESS Market Technologies

THE INNOVATOR'S DILEMMA

"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten."

Bill Gates, Co-founder of Microsoft

In a dynamic corporate environment, businesses can't afford to stand still. As we explored in our earlier article, remaining focused is one of the key components to long-term survival. Another is, investing in well managed research and development (R&D) endeavours.

We have explored this idea many times over the years, most recently in our June 2019 Quarterly Newsletter article titled "*Innovation + culture = success*". In this note, we profiled how some executives were prepared to invest ahead of the curve in order to drive market leading innovation.

One CEO who appears to do this well is Mike Cannon-Brookes of Sydney start-up and Nasdaq-listed Software as a Service (SaaS) provider, Atlassian. At the time we wrote, *"Cannon-Brookes and executives like him are encouraging a shift in the investor mindset, one which promotes and cultivates a culture of long-term thinking. It deserves our full attention because it fundamentally drives the right corporate responses of our leaders to view reinvestment and innovation not as a cost, but as a necessary requirement for continued success".*

While some of the most successful companies globally have shown leadership in this regard, many investors and indeed some boards are wary of management teams who attempt to do this.

In our recent travels, we discussed R&D and innovation with the management team of one of our portfolio investments. As believers in the need to self-disrupt, they introduced us to the work of Geoffrey Moore on the crisis of prioritisation that inherently exists within companies.

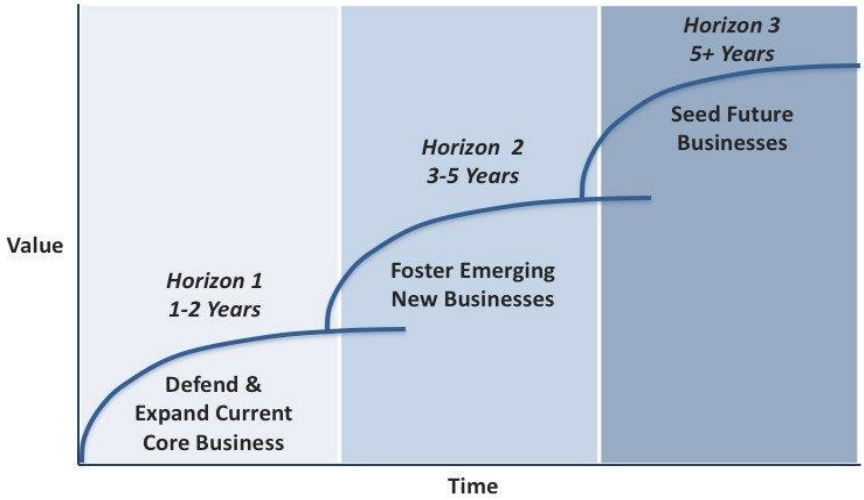
Geoffrey Moore is the Chairman, Founder and Managing Partner of TCG Advisors (TCG-A), a consulting practice that provides marketing strategy and organisational services to many leading high-technology companies as well as to those in other sectors.

Crisis of Prioritisation

One of the primary issues Moore attempts to address and help companies navigate is what he calls a crisis of prioritisation. This crisis arises when management attempts to balance the short-term expectations of investors against their long-term growth ambitions.

McKinsey's Three Horizons of Growth model has been referenced as a foundation for innovative strategy since it was articulated in 2000. As shown in Figure 1, the model is a useful way to visualise three horizons over which management are expected to execute existing short-term strategies, while simultaneously creating new capabilities.

Figure 1: McKinsey's Three Horizons of Growth



Source: https://www.stratechi.com/three-horizons-of-growth/

The first horizon covers initiatives that are short-term in nature. In essence, strategies or investments that are expected to drive a measurable result within one year. First horizon initiatives are usually palatable for most investors as they are designed to both consolidate the current business offering and protect against the loss of market share.

The second and third horizons include projects conducted over a longer period, with the expectation that they will deliver an increasing level of value proportional to the time investment.

Surprisingly, from his research Moore concluded that companies who have become obsolete with time weren't in fact failing to innovate in the third horizon. Indeed, many of the most prominent corporate 'failures' were executing well across all horizons; defending and expanding their current core business, while successfully seeding and developing future opportunities prior to their collapse. So why do they fail?

As mentioned earlier, difficulties arise when management attempts to balance the potential value that might be gained by adopting these innovations, against the disruptive effect they could have on their current operation.

Otherwise known as 'The Innovator's Dilemma', a term to describe the difficult choices businesses face between catering to the needs of current customers and shareholders and adopting new innovations and technologies that will answer future demands.

The simple truth is many management teams are unwilling to undergo the required investment in getting fledgling ideas off the ground at the expense of profitability to the core business. Blockbuster is an example of this, as evident in our earlier article. In a similar vein, Kodak's failure to adapt led to its eventual downfall.

The Kodak Story

Founded in 1888 by George Eastman and Henry Strong, the Eastman Kodak Company produced photographic film and camera products. For much of the 20th century, Kodak held a dominant position in the photographic film market.

Despite its enormous success, the company began to experience financial strain in the late 1990s as the market transitioned toward digital photography. Their initial slowness to embrace digital technology led to a botched turnaround strategy, which was too little too late with the company filing for Chapter 11 bankruptcy protection in 2012.

However, Kodak's demise was not brought on by a failure to innovate. In fact, they were the first company to develop a self-contained digital camera in 1975. Despite having access to the leading technology that the market sought, Kodak faltered because they were unwilling to disrupt their film business and take a gamble on this new technology, on the chance they would jeopardise their profitability.

For most large corporations, as Moore explains, "*bringing a disruptive innovation to scale is not a natural act… taking on a j-curve puts the entire organisation at conflict with itself*". This unwillingness to endanger a stable, successful core business isn't unique to Kodak with the same fate suffered by Motorola, MySpace, Yahoo and a host of others.

If you have further interest in the Kodak story and their ventures beyond photograph, we encourage you to read our December 2016 Quarterly Newsletter article titled "*Creation, destruction, photos and a Liquid Biopsy*".

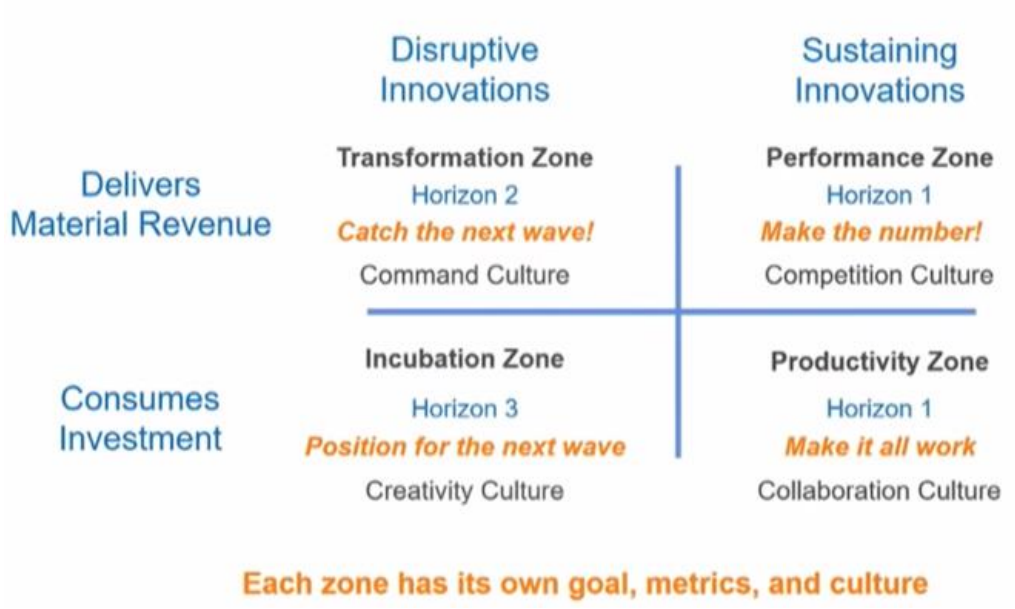
Zone Management

Moore argues the best defence against the crisis of prioritisation is an approach he dubs zone management. Within this framework, there is a recognition that there are legitimate conflicts of interest between different business segments that must be properly managed for the business to succeed. These segments can be broken down into four zones, as shown in Figure 2.

Each zone has its own goals, metrics and culture, operating over distinct time horizons. The performance, productivity and incubation zones, as Moore explains, naturally work together to drive sales, ensure operations succeed and create a pipeline of opportunities for the future of the company.

Focusing on these three zones is sufficient to drive strong corporate performance, satisfy investors and customers, and maintain the operations of the company. However, these alone won't protect a company from disruption. Moore outlines two situations which, if they were to occur, would potentially upset business as usual.

Figure 2: The Four Zones



Source: Geoffrey Moore Presentation November 2017

The first is termed Zone Offense, the process whereby a company may decide to pursue an opportunity and disrupt the market they are involved in. The second is Zone Defence, whereby a company may find itself on the receiving end of disruption, having to respond to protect their market share.

Zone Offense

After an idea, generated within the third horizon, has been adequately incubated and tested, management might decide to pursue a budding opportunity. However, for this to be successful, management must make this the central priority of their organisation.

Contrary to the popular saying *"don't put all your eggs in one basket"*, Moore outlines that successful ideas must be backed unreservedly. Diversity is not an option, focus is key. Re-writing the old adage, Moore notes that *"chickens lay eggs one at a time. If a chicken tries to lay two eggs at the same time, it's bad for the chicken and it's bad for the egg"*. For an idea to be successfully supported, it must be the number one priority across all business zones.

While all CEOs will find navigating the transformation zone (Horizon 2) difficult, Moore believes that founding CEOs usually see the most success due to their ability to demand change. This is evident when you consider the disruptive technologies delivered under the leadership of Steve Jobs, Jeff Bezos, Elon Musk and Reed Hastings, many of whom we profiled in the same June 2019 Quarterly Newsletter article mentioned earlier.

Zone Defence

More commonly, businesses find themselves on the wrong side of disruption. While investment into R&D is integral to ensuring companies stay ahead of the curve, the possibility of disruption is never too far.

The dilemma that many companies face, as observed by Moore, is that they are too focused on protecting short-term margins and profitability that they miss what's in their blind spot, a disruptive player entering the market.

The zone defence strategy outlines the transition a company must take, moving their core business offering from the performance zone into the transformation zone. This can be difficult to manage internally, let alone justify to investors, as it requires a shift in mindset from competitive-led operations to a driven, command culture.

Success in the transformation zone is dependent upon a willingness to re-enter the j-curve; a period of heavy investment, without any expected profitability to show for in the short-term. Microsoft's transition to a cloud-based offering is a great example of successful zone defence.

Microsoft

In its lifetime, Microsoft has faced many changes in market dynamics and consumer behaviours that have ultimately challenged their business model and relevance, the biggest of which has been the shift to cloud computing.

Founded in 1975 by Bill Gates and Paul Allen, Microsoft is responsible for a range of computing software and consumer electronics, the most well-known of which are the Windows operating system, the Office suite and the Azure cloud offering.

For many years, Microsoft very successfully operated an on-premise, licence-based model. The market shift to cloud and SaaS however opened a sizeable opportunity to compete against the dominant player in the space, Amazon Web Services (Amazon's cloud offering).

Prior to its shift to the cloud, Microsoft appeared to be losing its way as it failed to establish any notable presence in the smartphone and social media markets. At the same time giant digital platform companies, most notably Google and Amazon, were gaining traction.

However, the cloud served as Microsoft's saving grace. The dynamics of this market were starkly different to those previously experienced by Microsoft, requiring significant upfront and ongoing investment despite garnering only low margin returns.

Commenting on the transition to cloud and the onus on the business leader to drive change, Microsoft CEO Satya Nadella remarked, *"The one thing I realised more so as CEO is [that] we as leaders will have to take on the risk, because you can't go to the organisation and say 'Hey, here's a business that has got a margin profile that is much lower than the margin profile you enjoy, but I think we should be all in on it.*

You just don't go tell one of your direct reports, as a CEO, 'You should get fired if you don't succeed'.

And also, you're going to have a batting average. Not everybody's Don Bradman, but for any one of us who are mere mortals, as long as you have an about 50 average and you're a good businessperson – and to me that was the goal. And we missed mobile, but we're not going to miss cloud. Let's just go make that count.

Device platforms will come and go but the one thing that won't go away is the broad computing fabric that stitches all of this together."

Microsoft describes cloud as *"the computer of the world"* and the push into this market is strategically very important. Their main goal as a company is to help other businesses succeed. If they can add value then they will be indispensable, and cloud offers them this opportunity.

We have observed a similar transition with TechnologyOne, as it shifts its business from an on-premise license model to a subscription-based SaaS offering. This is a compelling offer for customers as they have immediate access to the entire suite of products the company offers, without having to manage any internal infrastructure.

Summary

At one point or another, all businesses will face disruption, self-induced or otherwise. Moore presents a framework by which companies can manage this period of transition in such a way as to protect the long-term sustainability of their business. While there is a constant need for R&D and innovation within businesses, investors must recognise that re-entering the j-curve is an essential aspect of building a company through a dynamic market.

This is an important consideration for us as we engage with management. Having the propensity and willingness to undertake this level of investment, with little to show for it in the short to medium term, but appreciation of the importance that it plays, requires outstanding management.

This is not for the faint hearted but rarely are the right decisions easy ones. We invest alongside management teams we trust as they aim to deliver long-term sustainable growth. ***SFM***

IT ALL STARTS AT THE TOP

When it comes to investing, there isn't a one size fits all approach. With this as a backdrop, investors are left with the task of connecting the dots every six months when new financial information comes to hand. But with so much happening beneath the surface, it is difficult for outsiders to fully appreciate what is really going on.

This information asymmetry, when combined with the economic and technological impacts of today, makes investing as challenging as it has ever been. At Selector we do not pretend to have the answers, acknowledging there is a lot more that we do not know.

So, what gives us the conviction to invest?

Ultimately it comes down to having enough confidence in those in charge, namely, the Chief Executive Officer (CEO) and key management team.

Although we are continually refining our investment approach and views on companies within our investable universe, what has remained central to our philosophy since day one, is the importance we place on having a high-quality management team that we deem trustworthy.

These are roles that involve significant personal commitment, carry immense responsibility and are open to ever increasing public scrutiny. CEOs, in particular, set the example both in a leadership sense and in establishing the right cultural setting. It is a role not for the faint hearted and one we have genuine respect for.

By better understanding the motives and rationale of the people behind the business, we appreciate the short-term setbacks that invariably occur while remaining steadfast in the long-term objectives.

This view is emphasised in our September 2017 Quarterly Newsletter article, *"Culture – Essential"*, where we stated *"Not everything is measurable. In reality, financial statements are but a snapshot, capturing a simple point in time. The long-term wellbeing of a business is often determined by far more than just numbers".*

"So, what makes an ideal leader? We would single out one attribute; the stewardship of a company's assets and its people, above all else. Shareholders expect their leaders to set the right example and deploy their capital in a sensible and disciplined manner. Leaders who approach the task as if it were their own capital are far more likely to make sensible decisions…The second entails an assessment of the team, both as individuals and as a collective unit, all driving towards a common goal…The two combined are important, if not critical, to a business' ultimate long-term performance. They also form the backbone of where we choose to go when selecting businesses."

In this quarterly edition we comment further on some of the key attributes supporting our reasoning for backing certain companies and their respective teams. Perhaps of more interest to some, is the Harvard Business Review's (HBR) annual *"The CEO 100, 2019 Edition"*, which was published in November. This ranks the top 100 CEOs within the S&P Global 1200[4] Index, using a combination of not only financial metrics in long-term total shareholder return (TSR), but also on environmental, social and governance (ESG) ratings.

Table 6 below summarises the Top 10 as well as a few notable CEOs on this year's list. Some interesting points to note include:

- Six of the ten CEOs operate within the Information Technology sector.
- There are no women, due to the low representation of female CEOs in the Global S&P 1200.
- The FAANG[5] CEOs aren't represented. Amazon's Jeff Bezos, a former number one CEO, is also missing entirely from the list this year due to his poor ESG record.
- The top five CEOs all have a tenure greater than 10 years.

[4] *Real-time, tradable global equity index with a composite of seven headline regional indices.*

[5] *Facebook, Apple, Amazon, Netflix and Google*

Table 6: 2019 HBR Top 10 and Notable CEOs

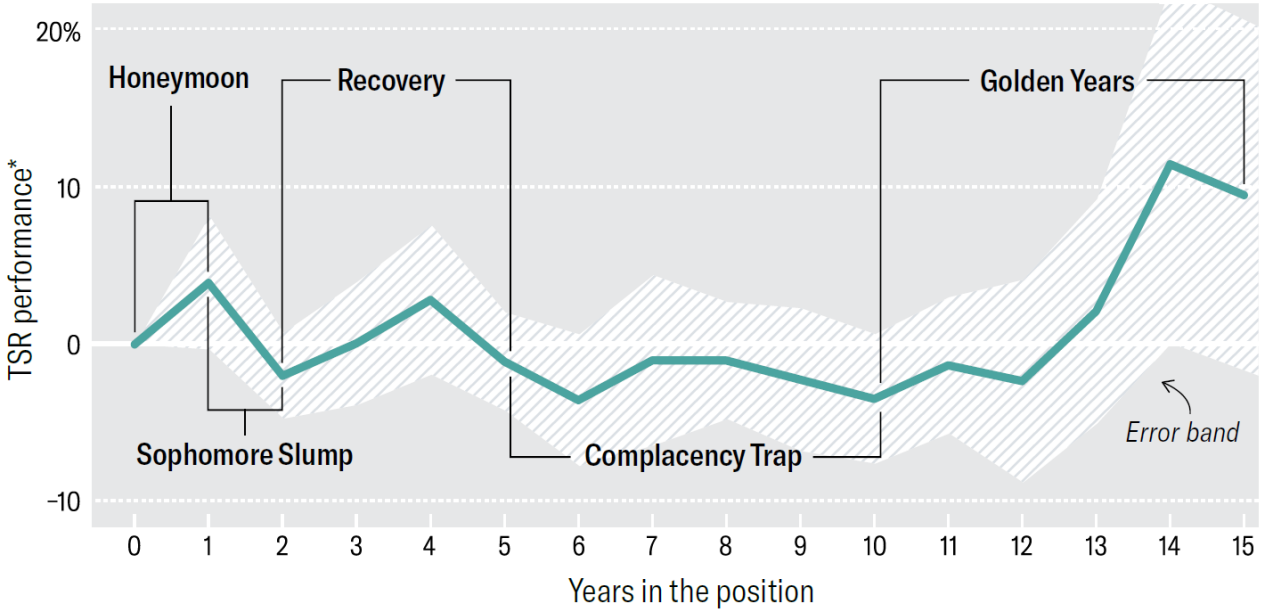
Rank	Name	Company	Industry	Country	Years
1	Jensen Huang	NVIDIA	Information Technology	United States	26
2	Marc Benioff	Salesforce.com	Information Technology	United States	18
3	François-Henri Pinault	Kering	Consumer Goods	France	14
4	Richard Templeton	Texas Instruments	Information Technology	United States	15
5	Ignacio Galán	Iberdrola	Utilities	Spain	18
6	Shantanu Narayen	Adobe	Information Technology	United States	12
7	Ajay Banga	Mastercard	Information Technology	United States	9
8	Johan Thijs	KBC	Financial Services	Belgium	7
9	Satya Nadella	Microsoft	Information Technology	United States	5
10	Bernard Arnault	LVMH	Consumer Goods	France	30
15	Bernard Charlès	Dassault Systèmes	Information Technology	France	24
25	Gregory Goodman	Goodman	Real Estate	Australia	24
83	Paul Perreault	CSL	Health Care	Australia	6
90	Colin Goldschmidt	Sonic Healthcare	Health Care	Australia	26

Source: 'The CEO 100, 2019 Edition', Harvard Business Review, Nov-Dec 2019

The CEO Life Cycle

In an additional study, the past tenures of 747 S&P 500[6] chief executives were documented. The resulting analysis revealed a surprising trend of headwinds and tailwinds that CEOs were expected to face during their period of appointment. Known as "The CEO Life Cycle", the study illustrates the non-linear nature of the role and the important part played by the board.

Figure 3: The Five Stages of CEO Value Creation



*TSR is market adjusted: Company shares may have shown a positive return for a given year but appear here as a negative number because they lagged the wider market.

Source: 'The CEO 100, 2019 Edition', Harvard Business Review, Nov-Dec 2019

[6] *Stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States*

According to HBR, The CEO Life Cycle is separated into five stages:

1. The Honeymoon – Year 1

As the name suggests, the honeymoon stage represents the CEOs initial year, typically entered with great enthusiasm and a fresh perspective. During this period, change is often assumed by investors as the key differentiator of success. However, the marker is in fact how much the CEO learns in this initial phase versus merely operates.

2. The Sophomore Slump – Year 2

The first challenge is likely to occur during the CEOs second year in charge, driven by unmet expectations rather than underlying problems in the business. This period is usually where the board has more regular engagements with the CEO, so it is important that they align their interests and form a strong working relationship.

HBR explains it well stating, *"CEOs who experience a deep sophomore slump are significantly more likely to be ousted in later years. High-performing CEOs told us that full transparency with the board, the leadership team, and investors helped them navigate the second year". Also mentioned, "Boards should ask critical questions during this period, but they should do so constructively and supportively."*

3. The Recovery – Years 3 to 5

Those who survive year two have now established themselves within the organisation, with the strategic direction and board dynamics now in place. This marks an ideal time for the CEO to come into their own, by introducing their ideas and initiatives into the organisation. Results are generally not forthcoming in the short-term, so CEOs can expect negative market responses.

Towards the latter part of this stage, the CEOs' suitability may begin to be questioned by the board. Those who do have board support and have performed well however may run the risk of becoming complacent.

4. The Complacency Trap – Years 6 to 10

The recovery period is invariably followed by a period of prolonged stagnation. Previous growth may not be sustained, and the risk of complacency is high at the CEO, board and managerial levels. *"The Innovator's dilemma"* also coincides with this period as CEOs are faced with the decision on whether to disrupt their traditional business, potentially forgoing short-term financial results for long-term success. Investing for the future is key.

At the board level, directors are also faced with a tough decision as HBR notes, *"Even if directors begin mulling a leadership change, they tend to be hesitant. 'The downside of a change in CEO seems huge to a board,' said one director. Our data suggests that boards should act decisively: Either accelerate the succession or protect the CEO from outside pressure."*

5. The Golden Years – Years 11 to 15

HBR regards *"The Golden Years"* as some of the best value-creating years for both CEOs and investors. The CEOs that have survived the formative years are starting to reap the rewards, *"When you survive into the golden years, it means that… you have not only managed the company well, but managed your board well, managed stakeholders, anyone who could call into question your continuing survival at the top."*

"Those who perform well enough to survive into their second decade on the job tend to experience a period of above-average performance", HBR also noted. However, this view deviates from the general industry consensus that CEOs should be replaced, as performance wanes after the formative years.

CEO spotlight

If we think about The CEO Life Cycle, a couple of recent examples come to mind.

Jayne Hrdlicka – A2 Milk[7] CEO Jul 2018 to Dec 2019

Hrdlicka was hired in 2018 to further transition the A2 Milk business within the infant formula and liquid milk markets. The company had already experienced extraordinary performance under the leadership of previous CEO Geoffrey Babidge, who had been in the role for 11 years. Coming into his *"Golden Years"*, Babidge had already delivered significant value for shareholders.

Hrdlicka initially began her career as a management consultant at Bain & Company, proceeded by a successful tenure at Qantas, most notably as CEO of Jetstar. Her previous experience gave her the confidence

[7] *Selector does not and has never previously owned A2 Milk shares*

to allocate greater spend in technology, consultants and marketing. During the *"Honeymoon period"*, Hrdlicka's approach was effective, with positive momentum realised in the company's expansion of Chinese labelled infant formula across Mother and Baby stores in China.

In her second year, Hrdlicka succumbed to the *"Sophomore Slump"*. Despite driving revenue growth of 41% and market share gains, forecasted higher investment spend in 2020 would impact operating margins. This was greeted unenthusiastically by the market with the share price dropping 13% on the day. For the board and some of the more vocal shareholders, this appeared a bridge too far.

On 9 December 2019, Hrdlicka stepped down stating demanding international travel and family commitments as the reason. It was also announced that Babidge would take over as interim CEO with immediate effect. The nature of Hrdlicka's exit, her short tenure, selling of shares, and an abnormally high spend on external consultants further muddies the water as to her real motives for leaving.

Interestingly, The CEO Life Cycle analogy would suggest that the board and CEO were not on the same page.

Paul Perreault – CSL[8] CEO Feb 2013 to present

CSL's CEO Paul Perreault features in this year's Top 100 CEOs list at number 83. Since taking the reins from previous CEO Brian McNamee in 2013, the path has not been all smooth sailing for the global leader in blood plasma manufacturing.

Slowing top-line growth and share market pressure to return capital were prominent issues when Perreault first took on the role. Yet his ability to obtain board support, augmented by a deep commitment in research and development (R&D) spend, has created a step change in business longevity and success.

Heading into his seventh year in the role, Perreault is showing no signs of complacency. CSL has now become a leading pharmaceutical company that has state of the art manufacturing facilities and plasma collection centres, which are highly cost efficient and deliver a diverse product range. Further investment in creating a broader R&D portfolio across various medical needs, highlights the commitment from Perreault and the executive team to reinvent the business in order to succeed long-term.

Although CSL currently operates in an industry with favourable supply dynamics, core to its ongoing success has been an unwavering commitment to its business values. This is coupled with complete buy-in from the board and management, reflected in the long tenure and exceptional financial performance.

Summary

We look favourably at CEOs who are not afraid to invest for the long-term, do not react to share market pressure and are focused. We also don't believe there is a right or wrong way to approach things. However, what we do know is that it all starts at the top and we are willing to back the right people when we meet them. ***SFM***

[8] *Selector owns CSL shares*

PASSAGE OF TIME

When you have been involved in financial markets for well over two decades you soon realise that an investor's best advantage can sometimes be the simple passage of time. In a recent office discussion, the question of whether a business we held was still appropriate, taking into account the company's slow progress in a key offshore market and an increasingly local competitive environment, soon led to a broader conversation.

It was a fair question and one debated on a combination of facts and opinions. Suffice to note that there are no certainties in whatever conclusions were drawn. However, if we were to focus on one point, it is in thinking that the financial outcomes of a business should be contained and measured within a designated timeframe. Chipping away for years with little to show for it is not what investors sign up for. Many want results in the here and now. Industry analysts are no better, quickly scurrying to adjust their discounted cash flow models when there are hiccups or delays. If only things were that simple.

The truth is a business can stay dormant for a long time, not because of inactivity but simply as an outcome of time and place. Our own experience in establishing Selector Funds Management included a long period, measured in years, where the personal investment and effort was not rewarded in the short term. In fact, the pursuit of our start-up to anything resembling success took the best part of a decade.

Our personal experiences have importantly shaped how we view any business investment. Internally, we refer to the many *"stepping stones"* that companies and management teams need to navigate over a long duration. Some will hit the ground running with immediate success, but in our experience, these are few and far between. The vast majority, either by design or default, end up taking the long road.

In 2019 when CSL celebrated its 25th year as a publicly listed company, CEO Paul Perreault noted that the company's extraordinary success to date was not by design, *"It's never been a goal to be the largest company in Australia. But it's because of the investments we make back into the business and the understanding, discipline and focus that we have that has got us to where we are".*

Former CEO of CSL and now Chairman, Brian McNamee notes the important stepping stones in shaping the group's direction in those formative years, *"I'm a great believer in narrow specialists, rather than broad conglomerates. You have a better chance of the entire organisation making insightful judgments when you are superbly knowledgeable and have a clear understanding of what you are trying to achieve".*

CSL management may have started out wanting to be one thing but this soon evolved, *"We wanted to create a great company, not just an Australian company. If you are not global, you may as well put up your hand and say I want to be bought".*

CSL is a clear example of how the early years are instrumental in setting up the foundations of a business, but ultimately an organisation's destination is crafted through its continuous shaping.

The successes of today are years in the making, plotted against a backdrop of missed opportunities, setbacks and management errors. We refer to these periods as the *"lost years"*. No one wants to be onboard when this is in train but in truth, this is the reality and at times unavoidable.

For an investor to stay the course you do need some financial and qualitative guide rails that can be measured. You can't just turn a blind eye and hope everything will work out. What you do need is a level of confidence, call it belief, supported by management actions that point in the right direction and provide a pathway to a better place.

Blackmores

Referring to our opening comments, the company in question is complementary medicines group Blackmores. In 2010, we profiled the company in our June Quarterly Newsletter. Much has evolved since that initial review. Back then, the board's appointment of CEO Christine Holgate in 2008 was starting to be felt internally and the company was relocating their headquarters to Warriewood, in the northern beaches of Sydney, a taste of things to come.

The business had until then, built a solid track record, backed by Marcus Blackmore, son of founder Maurice

Blackmore. As investors quickly learnt, Holgate brought speed to the decision-making process, removing unwanted obstacles in her pursuit of opening up new markets.

Financially the group ended 2009 in good shape. Revenues were a touch over $200m and net profits fell just shy of $21m. The company had a market capitalisation of $380m, carrying some $34m in net debt.

Holgate's appointment marked a key stepping stone in the company's evolution and as an external appointment, she acted without the additional baggage insiders can sometimes bring. This was also the era of China and the opening up of a brand new market. Blackmores navigated this new opportunity with feet on the ground and a preparedness to build a sustainable business. There were no shortcuts taken and it remains an important feature of Blackmores; aiming to do things the right way, in order to protect the brand and build longevity.

In our December 2018 Quarterly Newsletter, we wrote on the China opportunity following our visit to the country. Below is an extract from the report, *"Since entering the Chinese market in 2012 with its own Wholly Foreign-Owned Enterprise (WFOE) accreditation, the company set about building a China based business. Considerable resources have been invested with the China based entity now employing 60 staff. Building a business from the ground up is never an easy undertaking, and in this case, made more difficult when the operation is in a foreign land and where high-quality staff are in short supply due to intense competition".*

In our opinion, the recruitment of a high-quality country head for the China business is the group's highest priority. Currently operating without one, the goal of doubling staff over the coming year will be extremely challenging.

Prior to our trip, the Blackmores business was already in transit back home. The resignation of highly respected Holgate in 2017, following a nine-year career was unexpected and left the business exposed. The board in its wisdom played the safe card and anointed Richard Henfrey to run the business. Joining Blackmores from Telstra in 2009 and having acted as the company's chief operating officer in the three years prior to his promotion, Henfrey became the obvious internal candidate. In an organisation so strong on cultural values, Henfrey's appointment ticked all the boxes.

Unfortunately, his reign as CEO lasted less than two years. For the company this was a misstep at an important time for the business and the industry. The company was grappling with a number of internal and external challenges. None more so than the changing Chinese regulatory landscape and a slowdown in sales, following boom conditions in 2016.

This is best reflected in the financials, with reported sales net of rebates continuing to grow to $598m by 2016, while net profits peaked at $100m. In 2019 net sales amounted to $609m, while net earnings sank to $53m. The 50% drop in profits reflected an elevated cost base within the business and shrinking profit margins. In short, the company lacked the flexibility to adjust to a market slowdown, exacerbated by regulatory changes impacting the all important China trade, both in the local Australian market and offshore.

In the midst of these external impacts, the group was undergoing considerable change of its own across almost all aspects of the business. The company's board was in transition, with new Chairman Brent Wallace taking the reigns, alongside Marcus Blackmore who acted as interim CEO while a search for a new replacement continued. Senior executives including Head of Australia and New Zealand moved on, while others considered their options during this period of leadership-vacuum. In China, the long awaited appointment of a new head of country lasted a mere few months. As we highlighted in our earlier comments, this was an important appointment that had been too long coming and resulted in another misstep.

In the interim, some important operational decisions had also been made. This included the move into manufacturing, a role that the company had historically outsourced. To support a growing sales line, the necessity to source ingredients on better terms, while meeting stringent customer demands on quality and supply, required an important pivot by management. This led to the decision to acquire the group's largest outsourced manufacturer, Catalent Australia, for an initial $33m during 2018, with transfer of ownership taking effect in October 2019. This soft-gel and tablet manufacturing facility is described as *"world-class",* employing some 300 employees. The new facility is

referred to as Blackmores Braeside, located in Victoria and represents another necessary and important evolution in the company's progress.

Secondly, to combat the group's bloated cost base, a streamlined plan to save $60m over a three-year time horizon was unveiled in 2019. This would impact jobs and lead to a restructure of operations. However, the outcome would result in a better positioned group, with the benefits reinvested into marketing and the balance earmarked for shareholders.

Confirmation that the group was being buffeted from a slowdown in consumer demand, driven mainly by China's regulatory crackdown on unlicensed resellers, was revealed in the full year 2019 results commentary. The impact on e-commerce demand as well as restructuring charges would see the company report a lower first half net profit for 2020. At the group's Annual General Meeting the company confirmed that this would result in a net profit similar to the second half 2019, or circa $21m. For the full year, no guidance was provided other than expectations of delivering a stronger second half.

Yet despite these negative trends, all is not lost. The company's key Blackmores brand continues to resonate well within the domestic market and retains its number one market share position, with 15.9% of the Vitamins and Dietary Supplement (VDS) segment. In the group's Other Asia operations, including the regions of Vietnam, Korea, Indonesia, Thailand, Singapore and Malaysia, demand remains strong, with revenues jumping 30% to $107m and operating profits more than tripling to $7.5m. In comparison, China's in country sales and operating profits came in at $122m and $21m respectively.

For shareholders the big unknown remains the newly appointed CEO Alastair Symington, who joined the company on 16 September 2019, following an extensive executive global search. The board seems pleased with its decision, noting Symington's multi-brand experience and strong commercial background in the consumer goods space, having previously held roles with Nestle, Gillette and Procter & Gamble. Interim CEO and biggest shareholder Marcus Blackmore spoke transparently on the new appointment, *"I think he'll be able to make meaningful change. I'm confident that's what he'll do".*

CEO Symington's track record in China was another positive as identified by Chairman Wallace, *"His deep experience in emerging markets across Asia, and now the Middle East, but also specifically in China was incredibly attractive to us. Our growth opportunity in the region is massive and he just had such detailed experience with consumers, bricks and mortar retail, e-commerce. And importantly his experience in China is very contemporary and very relevant. The China market is dynamic and changes every year, so having that contemporary experience is very important".*

The upshot of the past year is a business that is in transition. A renewal of the board, new management, a cost restructure program, acquisition of a manufacturing business, alongside a more competitive, regulatory backdrop, illustrates the significant task at hand.

The Blackmores group remains the category leader in Australia with aspirations to grow larger offshore. The challenge is to take the company's core strengths of brand relevance and culturally aligned values to a greater international audience. While many may question the lack of science supporting the use of contemporary medicines, global demand for natural health solutions remains strong.

CEO Alastair Symington

In October, shareholders got to hear from the company's newest CEO, Alastair Symington. Along with the board, CEO Symington presented at the Annual General Meeting. It was also our first look at this new appointment.

Having spoken of the company missteps earlier, Blackmores could least afford another setback. While the business remains tied to *"Wellness"*, a global industry estimated at $4.2t and growing at twice the rate of the world's gross domestic product, it had opened itself up to new competitors.

In the VDS category in Australia, Blackmores leadership position has been retained but at the expense of gross margins. CEO Symington noted that key competitors were delivering margins of 63%, compared to Blackmores at 58%.

Margins are of course an end product of actions taken. In his address to shareholders, CEO Symington highlighted the five focus areas in his *"The Way Forward"* presentation:

1. Lead with purpose
2. Rejuvenate Australia
3. Sustainable growth model – Asia markets
4. Product and services – powered by education
5. Operational excellence

The first is particularly important and relevant. In our review of other businesses, what is abundantly clear is getting the corporate mindset right. Those that chose to lead, are better prepared to deal with challenges and uncertainties. It requires a total rethink, with a singular purpose of focusing on the core strengths and shedding unwanted distractions.

New leadership also involves linking the right people and skill sets to the strategy at hand. In the case of Blackmores, this is reflected by a host of new appointments undertaken by the CEO, including:

1. Gunther Burghardt – Chief Financial Officer
2. Ayumi Uyeda – Managing Director, ANZ
3. Kitty Liu – Managing Director, China
4. Dean Garvey – Managing Director, International

All come with strong credentials, particularly Burghardt who has 26 years' experience within the consumers goods and food and beverage industries, most recently as Executive Vice President, Operations at Treasury Wine Estates. Uyeda and Liu bring additional international experience from leading firms, including Yum! and Bayer respectively. Importantly, these appointments will report directly to the CEO, thereby removing obstacles and providing scope for quicker decision making outcomes.

The other four focus areas outlined above speak for themselves. A strong local operation is necessary if offshore is to succeed. Underpinning this is the backbone to any organisation of today, a preparedness to reinvest and drive operational excellence.

The message is pretty clear; run a better operational business, grow the top line, control costs, deliver higher gross margins, reinvest into new product and services, and remain customer relevant.

This is how we will track the progress of Blackmores over the near term.

Marcus Blackmore

Marcus Blackmore remains the company's largest shareholder with 23.1%. He has stepped down as an executive director but remains on the board. This is to allow the new CEO to run the business without distractions from its major shareholder.

Changes to the board have also been made, with current Chairman Brent Wallace planning to step down once new non-executive replacements have been appointed.

While Marcus Blackmore told fellow shareholders at the annual meeting, *"I'm your best insurance"*, the company is most likely highly attractive to others.

China Mengniu Dairy Company's recent $1.5b takeover bid for infant formula group Bellamy's, is equivalent to an earnings multiple of 29.6 times the group's recent underlying operating profits (EBITDA).

Crudely, if we were to apply the same multiple to the Blackmores operating profits of $91.4m for 2019, this would equate to $2.7b, or $155 per share.

Summary

If Blackmores were a house, you could describe it as having *"good bones"*. The business is sound, it is the market leader in Australia, profitable in growing offshore markets, carries a minimal amount of debt and generates excellent returns on equity and assets as reflected in Table 7.

While we have held Blackmores through some "*lost years"*, we are confident that the overall direction of the business is positive. New leadership, given the passage of time, can restore and with renewed purpose, new heights can be reached. If not, others are most likely to register their interest in this business with a strong and enduring brand. ***SFM***

Table 7: Blackmores financial track record 2015-2019

$'000	2019	2018	2017	2016	2015
Revenue	**609,502**	601,136	552,160	598,659	388,366
Earnings before interest, tax, depreciation and amortisation (EBITDA)	**91,414**	110,552	94,642	152,266	78,655
Depreciation and amortisation	**10,874**	8,940	8,411	7,045	6,391
Earnings before interest and tax (EBIT)	**80,540**	101,612	86,231	145,221	72,264
Net interest expense	**4,995**	3,930	4,180	1,810	3,432
Profit before tax	**75,545**	97,682	82,051	143,411	68,832
Income tax expense	**22,115**	28,459	24,023	43,391	22,276
(Loss)/gain attributable to non-controlling interests	**(39)**	(782)	(985)	12	-
Profit after tax attributable to shareholders of Blackmores Limited (NPAT)	**53,469**	70,005	59,013	100,008	46,556
Net debt	**94,484**	49,532	44,717	17,793	7,069
Shareholders' equity	**207,292**	192,875	177,541	178,263	132,915
Total assets	**490,928**	464,850	412,174	443,362	293,407
Current assets	**305,526**	302,507	258,662	294,624	187,844
Current liabilities	**150,509**	174,467	142,556	192,279	114,998
Net tangible assets (NTA)	**122,508**	123,869	107,369	116,484	90,809
Cash generated from operations	**51,806**	90,131	95,310	123,022	89,791
Number of shares on issue ('000s)	**17,362**	17,227	17,226	17,225	17,224
Earnings per share (EPS) - basic (cents)	**309.2**	406.4	342.6	580.6	270.7
Ordinary dividends per share (DPS) (cents)	**220**	305	270	410	203
Share price at 30 June	**$89.91**	$142.50	$95.84	$131.39	$75.27
NTA per share	**$7.06**	$7.19	$6.23	$6.76	$5.27
Cash conversion ratio[1]	**56.7%**	81.5%	100.7%	80.8%	114.2%
Return on shareholders' equity[2]	**25.8%**	36.3%	33.2%	56.1%	35.0%
Return on assets[3]	**16.9%**	23.2%	20.2%	39.4%	27.3%
Dividend payout ratio	**71.2%**	75.0%	78.8%	70.6%	75.0%
Gearing ratio[4]	**31.3%**	20.4%	20.1%	7.1%	5.1%
EBIT to revenue ratio	**13.2%**	16.9%	15.6%	24.3%	18.6%
Effective tax rate	**29.3%**	29.1%	29.3%	30.3%	32.4%
Current assets to current liabilities (times)	**2.03**	1.73	1.81	1.53	1.63
Net interest cover (times)	**16.1**	25.9	20.6	80.2	21.1
Gross interest cover (times)	**15.3**	23.4	18.9	63.9	18.8
% change on prior year					
Revenue	**1.4**	8.9	(7.8)	54.1	35.1
EBITDA	**(17.3)**	16.8	(37.8)	93.6	70.8
EBIT	**(20.7)**	17.8	(40.6)	101.0	81.6
NPAT	**(23.6)**	18.6	(41.0)	114.8	83.1
EPS	**(23.9)**	18.6	(41.0)	114.5	81.4
DPS	**(27.9)**	13.0	(34.1)	102.0	60.0

1. Calculated as cash generated from operations divided by EBITDA.
2. Calculated as net profit after tax divided by closing shareholders' equity.
3. Calculated as EBIT divided by average total assets.
4. Gearing ratio is calculated as net debt divided by the sum of net debt and shareholders' equity.

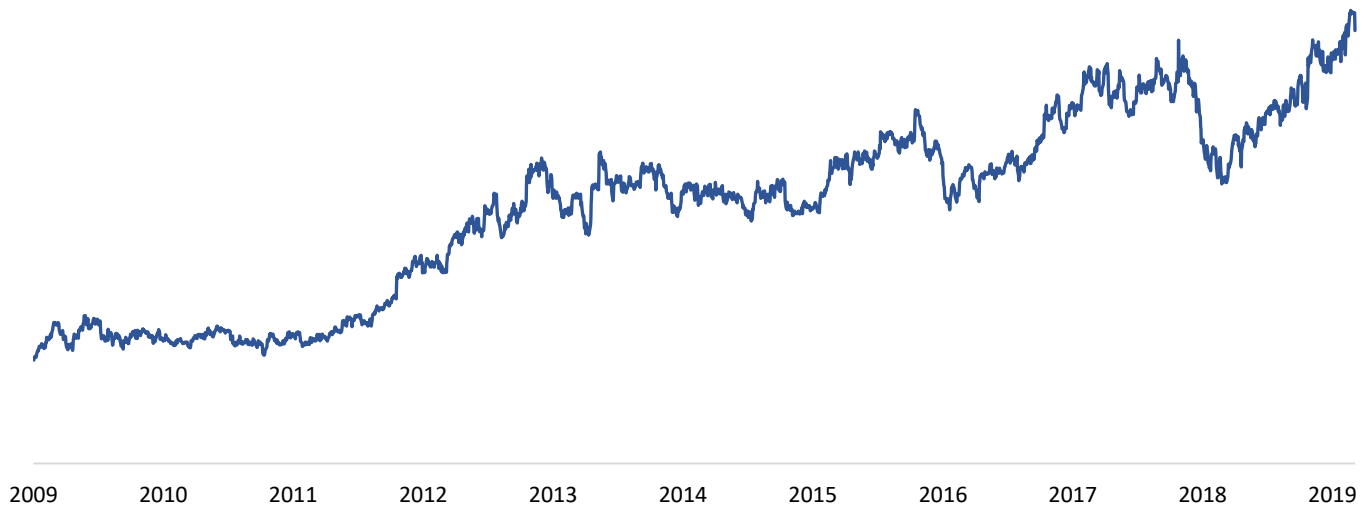
Source: Blackmores 2019 Annual Report

PICK A CHART

Below you will see two charts, representing the respective share price performance of two companies stretching back a decade. To be clear, we have taken the starting share price and the ending price and calculated the compound annual growth rate (CAGR) over the period.

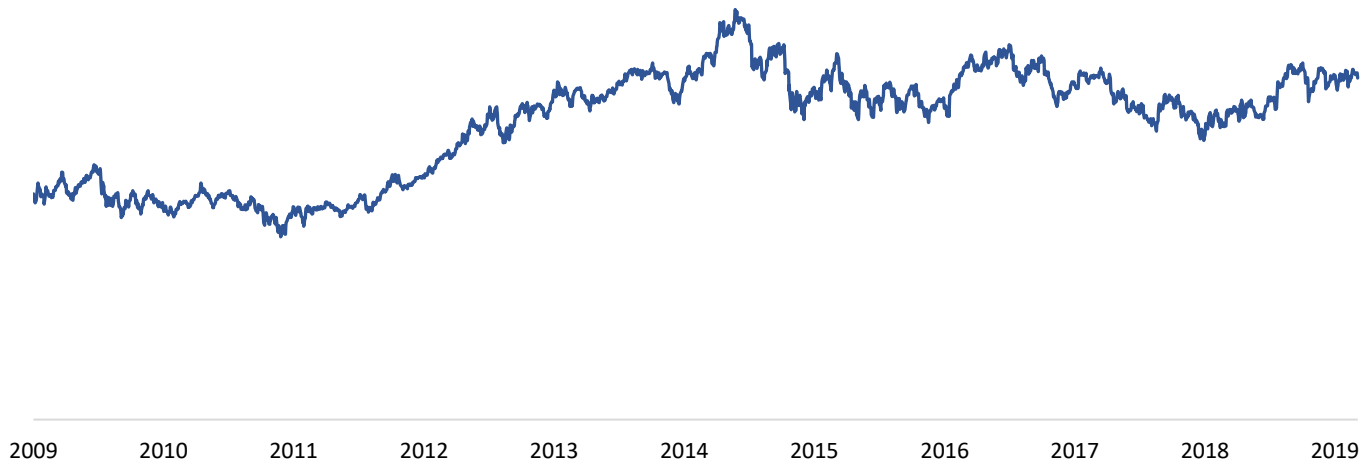
Chart 2 delivered a 16.2% CAGR while Chart 3 mustered up a 5.2% positive return. During that same ten-year time period, our main All Ordinaries Index delivered a 4.4% CAGR. We have removed the values in Chart 2 and Chart 3 to hide the companies in question.

Chart 2: Unknown Company #1 10-Year Price History



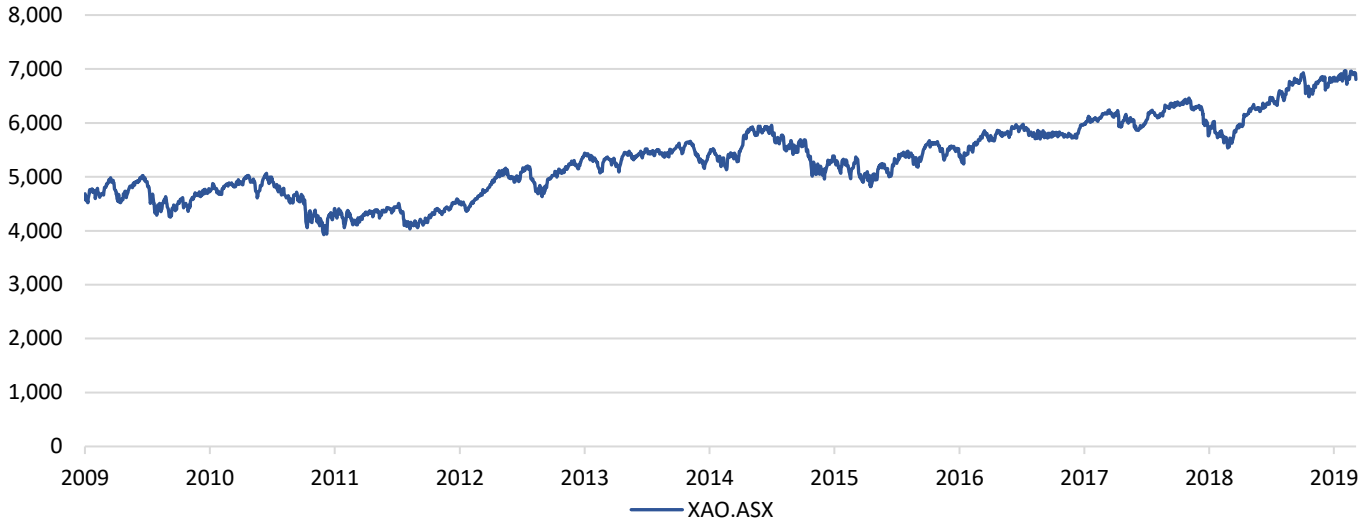
Source: IRESS Market Technologies

Chart 3: Unknown Company #2 10-Year Price History



Source: IRESS Market Technologies

Chart 4: All Ordinaries Index 10-Year Price History



Source: IRESS Market Technologies

Annual General Meetings 2019

When these two companies held their Annual General Meetings in late 2019, one got a clean bill of health from shareholders, with all resolutions passed. The other faced voter's backlash, with two resolutions contested, leading to a first strike on one and the failure of the other to carry. It would appear that the company had misjudged the mood and had asked for too much acceptance from a shareholder community that has become more combative.

Those that follow the market closely are likely to know the answer to the following. Of the two companies highlighted, one is our leading bank, Commonwealth Bank of Australia. The other is Australia's leading online automobile site, Carsales.com.

Can you guess which company is represented in Chart 2 and Chart 3? If you picked that Commonwealth Bank was denoted by Chart 2, you would be wrong. If you also said that Commonwealth Bank received the two negative votes on resolutions presented at its most recent annual meeting, you would be wrong again.

In fact, Commonwealth Bank has done incredibly well to escape the annual meeting unharmed, considering its mediocre CAGR over a ten-year period. Throw in the loss of its CEO during The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, and the resultant $2.1b of compensation and remediation provisions set aside so far, the lack of shareholder complaint is extraordinary.

In contrast, Carsales.com has delivered a stellar share capital performance over the same period. In this time the company has successfully expanded offshore, and in doing so maintained a consistency in its executive leadership ranks while repelling a long list of online competitors. Its only blemish being the part purchase of the Stratton Finance operations for $60.1m in 2014. The subsequent regulatory enquiry undertaken by the Australian Securities and Investments Commission (ASIC) banning flex commissions, which had provided car dealers and brokers bigger payments for signing customers up, put a handbrake on its growth. The decision to exit and put up the 'for-sale' sign came in the back half of 2019.

So why have shareholders given Commonwealth Bank the green light while Carsales.com has been handed out a red card?

Without knowing all the ins and outs of voting preferences, one thing is clear, there is a new, powerful force when it comes to annual meetings, namely the proxy advisors.

Proxy Advisors

These are organisations that provide research and voting services to shareholders, primarily institutional investors.

In some instances, the proxy advisors are owned by the investors in which they represent, namely a collection of the industry superannuation fund providers.

Proxy advisors seek to provide a collective voice on a range of issues including remuneration, as well as environmental, social and governance matters. As businesses are increasingly complex, proxy advisors attempt to engage with pertinent issues that may influence how their clients should vote.

Whilst they serve important purposes for their constituents and we support the independent voices, not all proxy advisors are the same. Some look to address company matters at meetings on a case-by-case basis, while others take a blanket approach that looks to impose an outcome irrespective of circumstances.

The power shift to proxy advisors, largely a result of the increasing level of company ownership by the industry super funds, has given rise to a collective, unified voice that aims to effect change. In addition, many investors, including the industry's asset managers, have abdicated their duties to vote, leaving the door open for proxy advisors to dominate proceedings.

In our December 2016 Quarterly Newsletter article titled, "*Voting – it does matter"* we put forward our case as to why shareholders should vote at meetings. Our reasoning? The silent majority often don't vote while the noisy ones do. As we can see in the case of Carsales.com, the outcomes inflicted are not always in the best interests of long-term shareholders.

When we delve a bit deeper into the Commonwealth Bank and Carsales.com resolutions, it would appear in the case of Carsales.com the biggest disagreement between the company and proxy advisors centred on the treatment of Stratton Finance. More specifically, the non-financial metrics used in determining the payment of short-term incentives and the setting of long-term performance hurdles.

The Carsales.com board elected to treat Stratton Finance as it would treat any asset sold. For short-term incentives, gains would be excluded but losses considered. For determining long-term incentives, both gains and losses would be excluded. In this specific instance the ASIC investigation into the finance industry significantly altered its viability, an outcome that was outside management's control. It would appear both fair and sensible that any asset impairment incurred in the year should be reflected in any decision to pay short-term bonus payments but unfair to extend that in the determination of long-term performance targets stretching out three years and beyond.

In the 2019 Carsales.com Annual Report, page 58, the board applied the impairment charge related to the Stratton Finance loss in determining the group's adjusted net profit. In doing so, only 37% of potential short-term incentives for the CEO were earned and awarded for the year, amounting to $367,350. It's worth highlighting that if the company had instead sold the business for a gain, the board would have excluded this from their calculation. One-sided yes but an excellent outcome for shareholders.

The other significant point of contention surrounds the use of non-financial targets in the setting of short and long-term incentive outcomes. Some argue it should be solely financially driven, with clearly set objective targets. While others, including the Australian Prudential Regulation Authority (APRA), see the need to incorporate non-financial metrics to drive desired outcomes.

The proxy advisors, quite evidently, weren't in favour of Carsales.com use of non-financial metrics in determining both the short and long-term incentives for the group's CEO. For the financial year 2020, the company proposed lifting the non-financials contribution, labelled *"Strategic Objectives",* from 30% to a possible 40%. As such, the two financial hurdles making up the remaining 60% would be focused on hitting what the company terms *"look-through revenue targets"* and *"adjusted earnings per share".*

The strategic objectives were not necessarily driven by short-term financial outputs. Rather they were centred on the importance of projects vital to promote future sustainability and growth in the business, and are as follows:

- International business performance metrics that reflect the strategic importance of this segment to the group as a whole.
- Trust and brand metrics that represent the importance of reputation to the group's success.
- Domestic business milestones that indicate successful implementation of the group's strategic roadmap.

A partial achievement of these objectives, as determined by the board, would provide a 50% vesting outcome for executives, while full achievement would deliver 100%.

For the proxy advisors and their collective shareholder base, this was a bridge too far. Their advice to vote against this overwhelmingly swayed the polls, with the resolution failing to carry on a 52% to 48% vote basis, a knockout result to say the least. The shareholders who chose not to vote (25%) either didn't care, were complacent or happy to allow the more vocal and organised to dictate terms.

While non-financial metrics lack key end point targets and thus are harder to measure, their importance in achieving long-term success should not be undermined. It should not be forgotten that a company's board is in place to guard and act as custodians of shareholders capital. If we question the merits of paying out performance incentives based on non-financial outcomes, we are indirectly questioning the role of company boards to do their job as elected by the shareholders. You can't have it both ways.

While Carsales.com bore the brunt of proxy displeasure, a different story was being played out at Commonwealth Bank. Judging by the voting response it would seem everything was running ever so smoothly. The mere fact that the bank, along with its major competitors, were dragged over the proverbial coals by APRA during the Royal Commission didn't appear to register.

Nor did the massive fines and compensation payments that have stretched into the billions. While CEO Cameron McIntyre over at Carsales.com couldn't get the green light on his long-term incentive plan, which included 40% non-financial metrics, his counterparty at Commonwealth Bank had no trouble securing the numbers.

Commonwealth Bank CEO Matt Comyn received a 94.63% yes vote for his 2020 long-term incentive package. It perhaps might surprise some readers to learn that in determining the award, 75% is predicated on hitting financial return metrics. The remaining 25%, made up of non-financial outcomes, centred on meeting trust, reputation and employment engagement metrics.

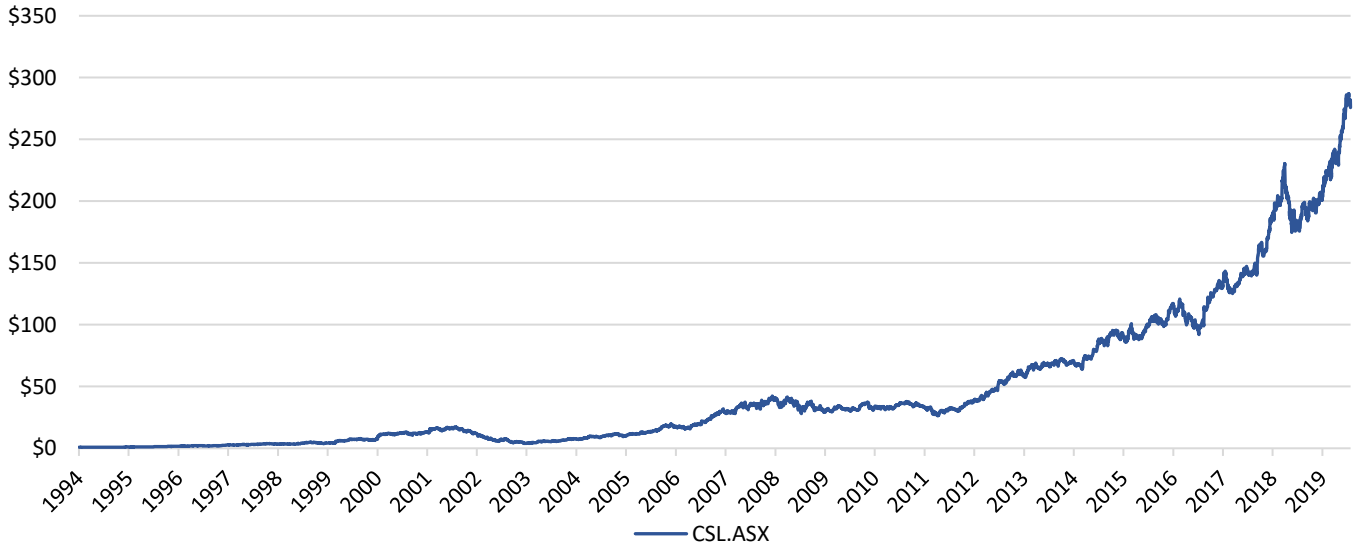
Proxy advisors obviously forgot to vote on this occasion, making a mockery of their dislike for non-financial metrics, which only highlights the inconsistency of the collective vote.

Voting consistency or the lack thereof

In its 25 years as a publicly listed company, global blood plasma leader CSL has had only two CEOs in charge; Brian McNamee between 1990-2013, followed by current CEO Paul Perreault from 2013 onwards.

The business originally floated at $2.30 per share in 1994. However, given the share splits the company has embarked on, the adjusted entry price is now equivalent to around 76 cents. Over that period the share price has grown at a compound annual growth rate of 25.2%, reflected in Chart 5.

Chart 5: CSL Price History Since Inception



Source: IRESS Market Technologies

In celebrating its anniversary, CSL noted, *"When the company listed, it had revenue of A$193m compared with US$8.5b in revenue in 2019. CSL is now the third largest publicly listed company in Australia and fifth largest biotech company globally with a market cap of $A111b and more than 25,000 employees and sales in nearly 70 countries. Since listing, the company has returned US$7b in cash to shareholders via share buy backs representing 29% of issued capital".*

CSL is a global business in every regard, run by an exceptional executive team, led by their highly respected chief executive Perreault. Yet in 2016, proxy advisors took exception to the *"U.S.-style"* trend in CEO Perreault's salary package, which rose from US$5.8m to US$8.1m. Of this lift, the base salary rose marginally from US$1.77m to US$1.85m, while short-term performance payments added US$1.3m. It mattered little that the CEO was running a leading global business that rightly demanded a competitive remuneration package.

We wrote of our displeasure regarding the proxy attack on CSL's CEO in our December 2016 Quarterly Newsletter, *"Since listing in 1994 the company has delivered compound annual growth in net profits of 23% while the share price has done a little better, growing at an annual rate of 25%. All this is not to say that we should close our eyes to excessive remuneration behaviour but of all the companies to pick on, CSL is certainly not the one. In fact, anyone who even remotely understands the complexity and duration of taking a drug to market would acknowledge the extraordinary achievement that this and previous executives have delivered".*

At the meeting's conclusion in 2016, the company received its first strike against its remuneration report, with 26.5% voting no. CEO Perreault also copped a 26.5% no vote against his long-term incentive plan, although both resolutions were successfully carried.

Over the past three years, CSL has avoided further strikes or proxy advisor displeasure. In fact, in 2019 both the remuneration report and the CEO's share performance grant were passed with over 90% in favour. If the proxy advisors deemed the remuneration amounts excessive in 2016, why is 2019 any different?

Perhaps it speaks to the inconsistency of how these advisors apply their trade. Fortunately, others in the industry have a different take on what is important.

As mentioned earlier, the Harvard Business Review (HBR) named CEO Perreault among the Top 100 Best Performing CEOs in the world for 2019. CEO Perreault was ranked at number 83.

Throwing stones

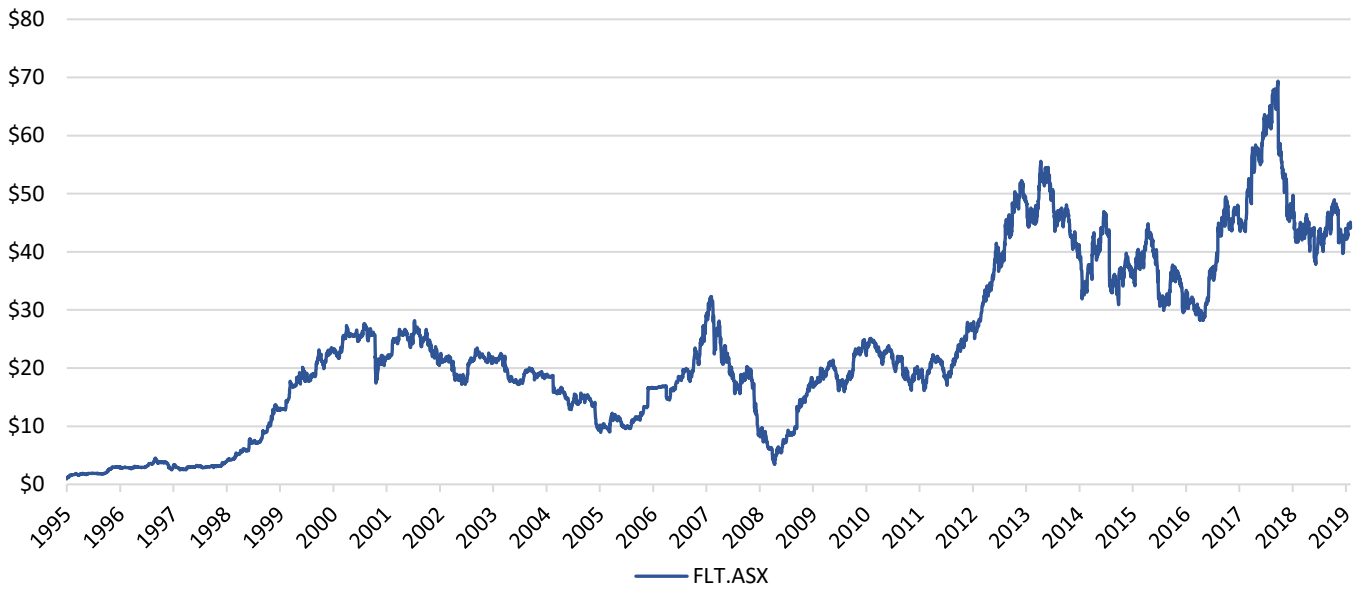
Over at Flight Centre Travel Group, proxy advisors led by Ownership Matters took umbrage to the level of gender diversity on the board. In the firing line was the resolution to reappoint current Chairman Gary Smith to the role, a position he has held since 2007. Flight Centre operates with a small board of five members, which includes its co-founder Graham Turner.

The business has over its corporate life delivered significant value to shareholders by successfully expanding offshore, largely funded from internally generated cash flow. To put this into perspective, Flight Centre has delivered a 17.5% compound annual share price return since its IPO in 1995 and paid out $20.76 per share as dividends.

Among its staff base, females make up 76% of the group's locally based operations, covering some 10,600 employees. Considering all activities, over 70% of staff members are female, including over 44% of Flight Centre's senior leaders.

Flight Centre's Chairman Smith was returned with a majority but the protest vote of 14.9% certainly leaves a sour taste.

Chart 6: FLT Price History Since Inception



Source: IRESS Market Technologies

Summing up

We choose to vote because it is responsible and represents how we operate. Our voting decisions are predicated on what is best for the business and shareholders over the long run, noting that there is always give and take in any successful relationship.

We go to some lengths to understand the contentious issues, engaging with companies and executives in pursuing change where it is warranted.

Our overarching approach is to answer two basic questions when considering company resolutions, particularly those concerning remuneration and performance metrics.

- Are the shareholders doing well?
- Is the company achieving its targets?

The danger in applying a blanket, 'vote no' approach, is to push for change without appreciating the damage that it can cause. Despite being confronted with a proxy attack back in 2016, CEO Perreault didn't leave CSL. Good executives are rare and his track record at CSL since 2013, and even stretching back to 2004 when he first joined, is acknowledged by others. This is not to suggest that boards and executive shouldn't be challenged, but there are consequences when this is undertaken with little thought or accountability of the outcomes.

CEO Cameron McIntyre, similarly, has been with the Carsales.com[9] business since 2007, starting off as its chief financial officer, before moving into operations and then finally into the chief executive role in 2017. Having been singled out by the proxy advisors is disappointing and, in our opinion, does more damage than good.

Time will tell whether this vote turns out to be a costly one for all shareholders. ***SFM***

[9] *Selector on behalf of its investors owns shares in CAR, CSL and FLT and voted in favour of all resolutions at the 2019 Annual General Meetings.*

PAPUA NEW GUINEA TRIP

We approach all our investments with a long-term mindset and as a result, short-term bumps often occur along the way. Three near term catalysts, or bumps, were front of mind as we landed in Port Moresby, Papua New Guinea (PNG) in late November to tour a selection of Oil Search and Exxon assets. All three should see a resolution of sorts by early in the new year. They include:

1. Progress on the P'nyang Gas Agreement between the joint venture partners and PNG's Marape government.
2. Results of drilling of the Gobe Footwall exploration well.
3. Progression into the Front End Engineering and Design (FEED) in Alaska and an upgrade to the Pikka unit reserves.

We comment on each of these events and make some other cultural observations below, particularly around the safety culture and changes to the in-country relationship management.

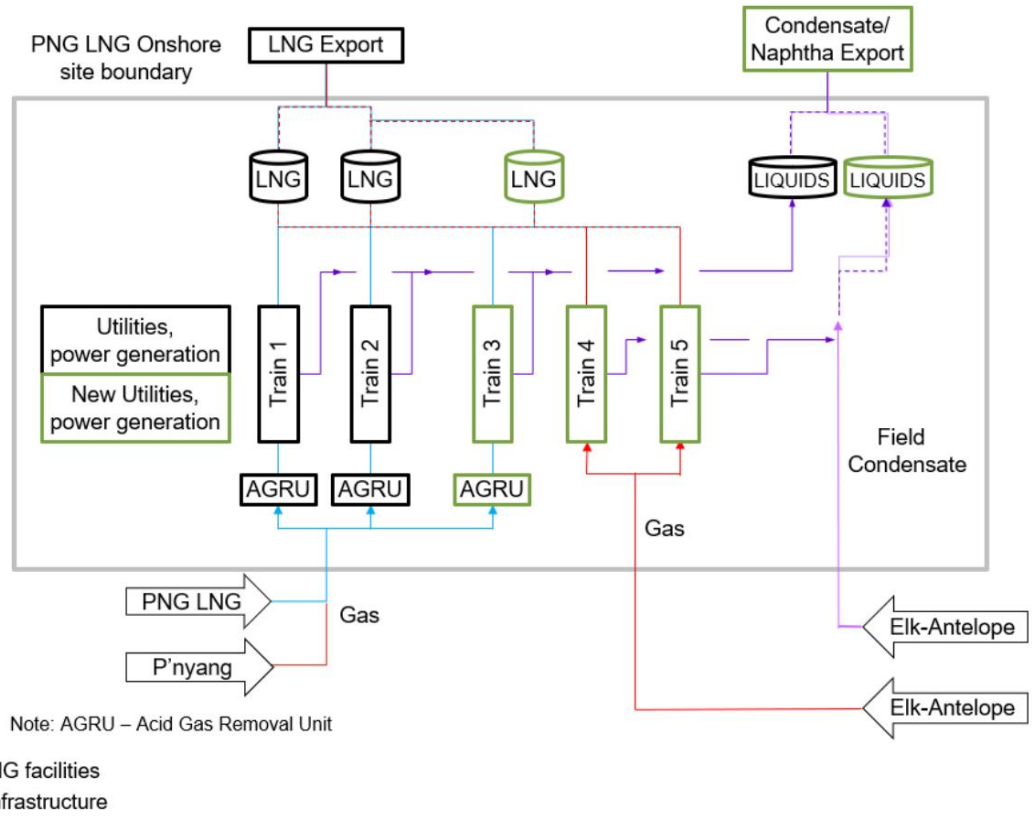
Tough negotiations are to be expected with any commercial development, particularly one that will shape the fortunes of an economically weak sovereign nation. As rich as PNG is in culture, language and beauty, it is the 153rd most developed country in the world out of 189. According to the United Nations, it's doing slightly better than Syria and marginally worse than Myanmar. Based on these statistics, the new government's starting point for negotiations is not from a position of strength.

Adding to the challenge of inking the P'nyang Gas Agreement (a component of the Papua Gas Agreement which has been validated), are the reported emotional exchanges between joint venture representatives and the government. This needs to be rectified in the short-term if progress is to be made. During our visit, veteran CEO of Oil Search (OSH) Peter Botten stepped in with the aim of bridging the void. He described this round of negotiations as the toughest he has experienced in his career.

Figure 4: Moro Airfield at the foot of PNG Highlands

Source: SFML PNG Trip

Figure 5: Two-train PNG LNG Schematic with three-train Papua LNG Project



Source: Oil Search PNG Field Trip Presentation – November 2019

Unscrambling the egg, that is the integration of the proposed three-train Papua LNG Project into the existing PNG LNG project, without an agreement on P'nyang, will be a messy affair. Figure 5 sets out the proposed configuration of the existing PNG LNG plant site.

Following our visit to Port Moresby and the Highlands region, we continue to hold the view that common sense will prevail in PNG. While no sovereign government wants a gun held to its head, it appears to us that the Marape government has few alternatives other than to proceed under terms, which are commercially acceptable to the joint venture partners who are publicly listed international corporations. Ill-conceived demands from less than sophisticated consultants will not propel the interests of the Marape government forward.

We highlight some of the cultural issues that bubble just below the surface. Our thinking is that continued inaction from the government is likely to be an unpopular pathway.

In May 2019, former finance minister in the O'Neill government, James Marape was elected as the eighth Prime Minister of Papua New Guinea. Marape is also a leader of the Huli people (one of the largest tribes in the country) and he defines his life by their ancient customary code of trust and loyalty.

The Huli

Carved out from the Southern Highlands Province, Hela is the home of the world famous Huli Wigmen.

Figure 6: Huli Wigmen ceremonial dance at Ambua lodge

Source: SFML PNG Trip

This tribe has a unique process of parenting and preparing men for adulthood. Men and women have historically lived separately, although we understand strict cultural adherence to this is diminishing. Boys live with their mothers until they are seven or eight years old. Thereafter, they go to live with their fathers to learn how to become men.

At 14 or 15 years of age they enter bachelor school for up to three years, where they learn about the biological and ritual processes of becoming a man. During this time, they are forbidden from contact with any female, including their mothers. It is believed a combination of magic and diet helps the young boy transition into a man and helps his hair grow more quickly.

As his hair grows, it is gradually shaped using a circular band of bamboo into a figure resembling a toreador's hat. After 18 months, it is clipped off close to the scalp and woven into a traditional Huli ceremonial wig by the wig master. Other adornments are also added, including feathers of the bird of paradise, cassowary bone, pig tusks and red ochre.

Regardless of whether it's an everyday wig or a ceremonial wig, each must be created before the man is married. The wigs can also be sold to men who don't care to grow their own.

The number of pigs a Huli owns is a measure of his wealth. The pigs, which live in deep trenches that criss-cross the Tari basin, are used to pay a bride's dowry (multiple wives are permitted), to pay death fees or other ritual payments. These trenches also define family boundaries and guard against enemy invasions.

The tribe has no chiefs. Instead leaders are determined by their warmongering and dispute-solving abilities, as well as the number of pigs they own. The Huli live a life of vengeance and warfare rather than peace. They described their turf wars to us as resembling that of a game of football, where the wounded (or dead) can be removed during breaks. This ancient culture can sometimes have a little bit of a Wild West skew to it.

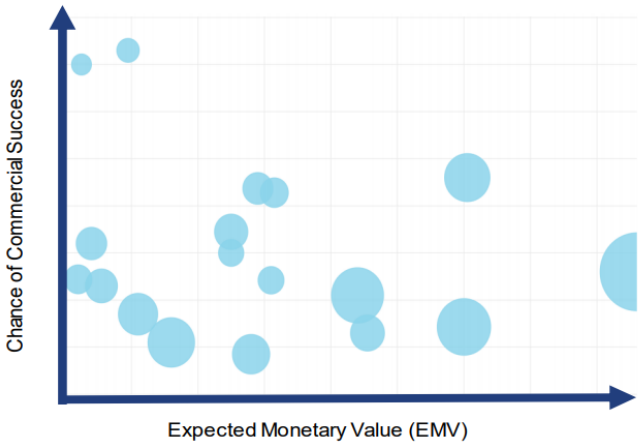
It sounds farfetched. To help put it in perspective, the international lodge we stayed in, Ambua lodge, had been closed to tourists for a year prior to our visit due to security concerns, after it had come under gun fire.

The province of Hela itself inherited little infrastructure, poor roads, a broken health and education system, and until recently it had no electricity. The then Finance Minister Mr Marape promised to fix this for his Huli people, using the expected millions in royalties from PNG's first LNG project, but progress was much slower than expected.

A combination of the battered global oil markets, optimistic political promises and diverted funds meant the expected windfalls from LNG never eventuated. This experience is not unique to the Huli. Social disquiet, well known to the government, sits just below the surface in this traditional society.

Figure 7: 80 prospect OSH pipeline

- OSH's PNG portfolio contains 11 billion boe gross unrisked exploration potential with net EMV of > US$1 billion
- 80 prospects in portfolio; plot shows example of prospects ranked according to value and chance of commercial success
- Low risk relative to other global exploration activities, as extension of existing proven plays
- Risked finding cost estimated at ~US$1.5/boe*
- Variety of options to choose from: multi-hundred million barrel/multi-tcf high value options with higher risk to moderate value very low risk options near to existing infrastructure
- Near term drilling decisions driven by capital allocation and synergies with existing infrastructure. No near term commitment exploration wells



Source: Oil Search PNG Field Trip Presentation – November 2019

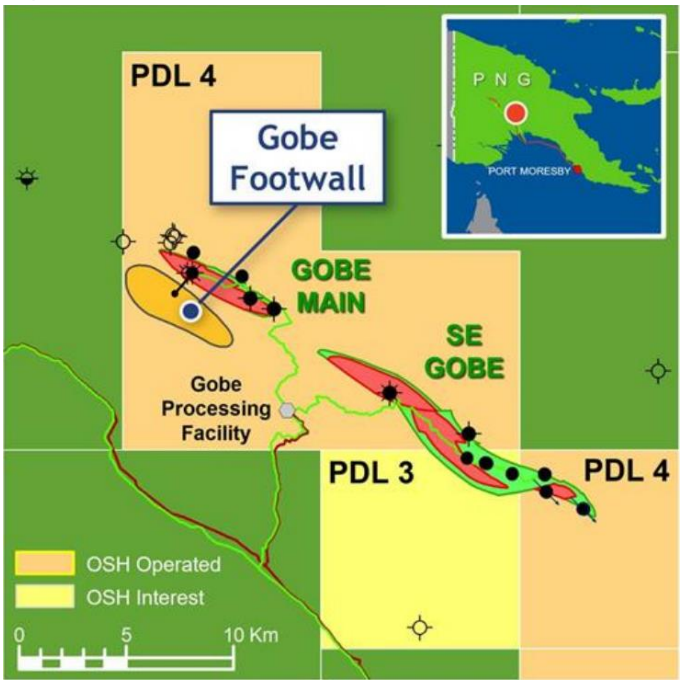
Gobe Footwall

Tribes and family units who reside in and around the Gobe oil fields have a similar history of simmering tension. The root cause here is years of stranded royalty payments.

The Gobe Main field was first produced in 1999. The original discovery of 40-50mmboe[10] is today in sharp decline. If this field was to shut down and the large local workforce became idle, this apparent serene social setting could quickly turn volatile.

Oil Search has 80 prospects in its unrisked exploration portfolio. Figure 7 depicts how they are ranked according to value and chance of commercial success. At a cost of some $48m, the Gobe Footwall exploration well was spudded on 12th November. It was successfully drilling ahead to its 3,504m target when we visited the site. This is the first exploration well in five years and is a key target both from a financial perspective and a social imperative, more on the latter below.

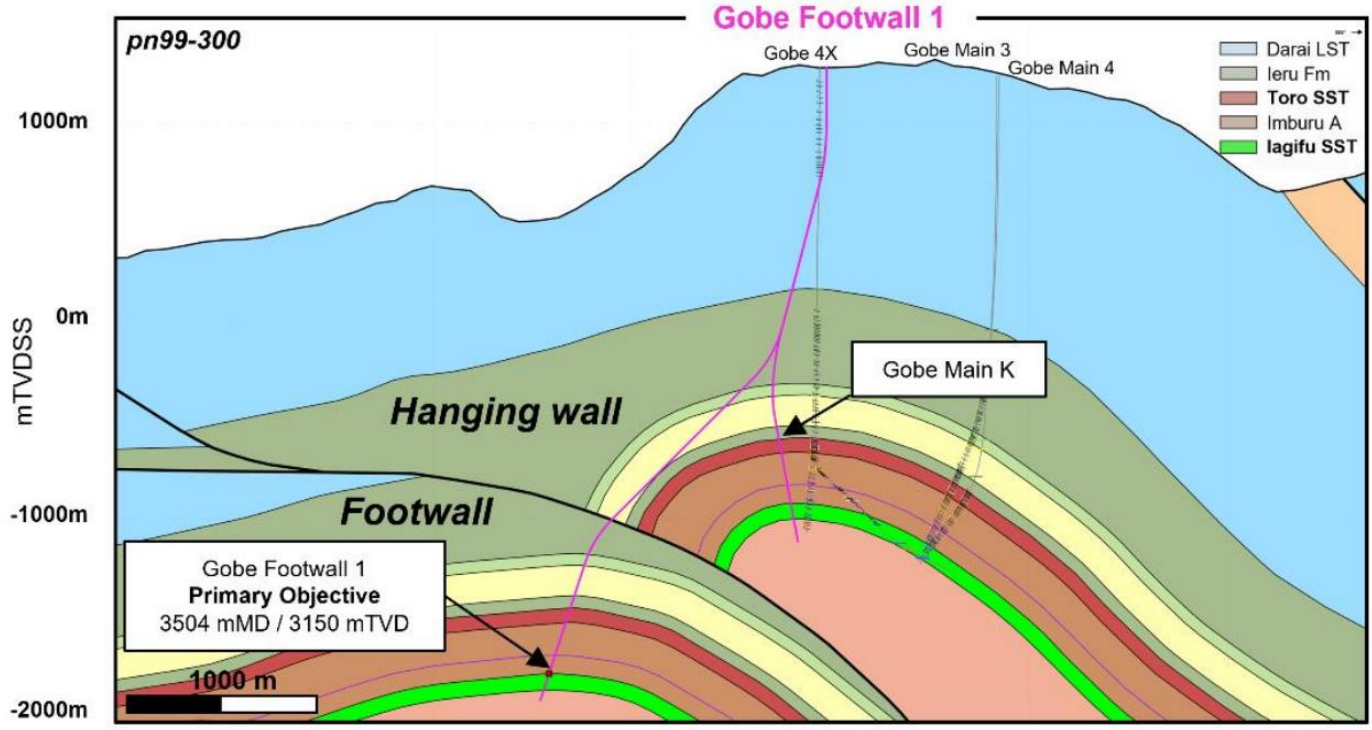
Figure 8: Gobe PDL



Source: Oil Search PNG Field Trip Presentation – November 2019

[10] *mmboe - Million Barrels of Oil Equivalent*

Figure 9: Gobe Footwall



Source: Oil Search PNG Field Trip Presentation – November 2019

Oil Search has had considerable success in drilling footwalls (the two sides of a non-vertical fault are known as the hanging wall and the footwall, see Figure 9), with some seven out of eight footwall style targets drilled to date, resulting in discoveries.

In terms of potential, the Gobe Footwall could conceivably be a repeat of Gobe Main. However, a more conservative 25mmboe would be a significant discovery, while also playing an important role in the social fabric of the province.

A multi-generation dispute between local landowners has seen royalties, totalling tens of millions of dollars, build up in trust since 1999 rather than being dispersed. Apparently, the older generation would prefer to go to war rather than give ground, while a younger generation of the same clan is inclined to share the bounty. In any case, we understand that if the Gobe infrastructure was dismantled, in the event of a shutdown of Gobe Main, decades of local tensions may quickly turn to violence. For this reason, the Gobe Footwall would be a welcome discovery for all. The initial results of this well should be known early in the new year.

Bold promises require deals

Marape gave a bold maiden speech as Prime Minister on the 25 July at the Lowy Institute where he stated, *"It is my dream that Papua New Guinea becomes the richest black Christian nation in the world"* within a 10-year time frame.

In response local newspapers reported, *"The current titleholder is the highly industrialized economy of Trinidad and Tobago, where the average resident earns around 833 percent more than those in Papua New Guinea."*

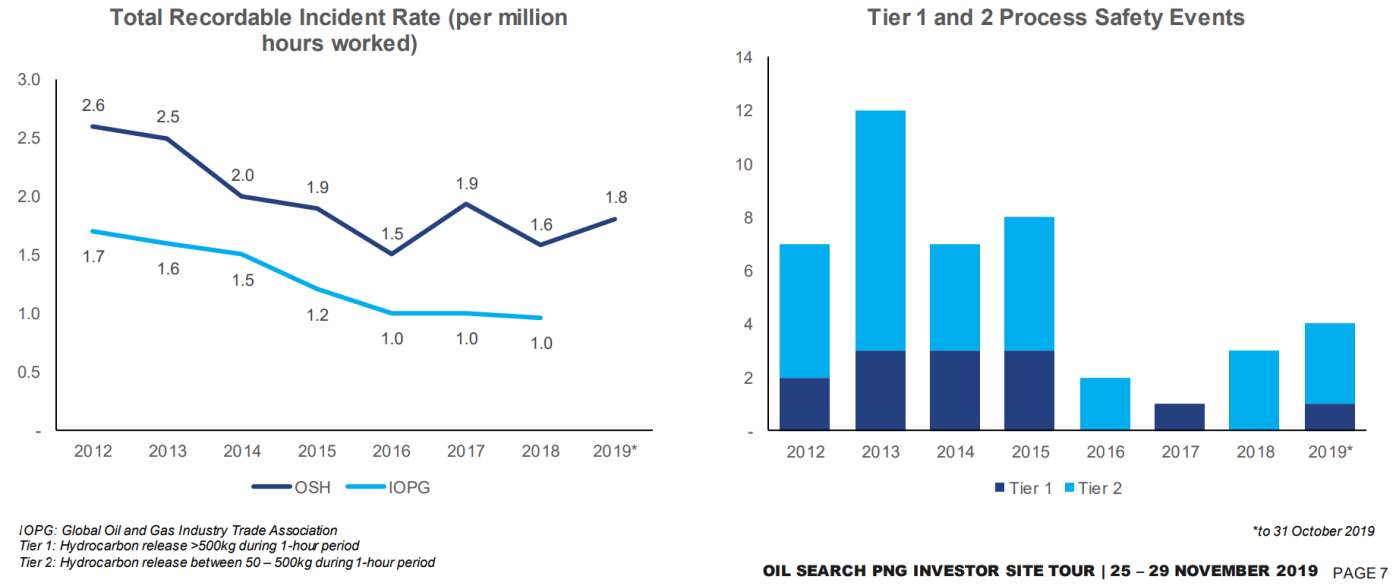
If national economies were like football teams, then Papua New Guinea would be near the bottom of the table struggling to avoid a relegation dogfight.

Violent crime and corruption are endemic, reliable electricity is rare, and population centres sit like isolated city-states, surrounded by trackless jungle and mountain ridges that soar into the equatorial sky.

Papua New Guinea's economy would have to grow at a world-beating rate of around 30 per cent every year for the next 10 years just to catch up (to Trinidad and Tobago).

"PNG has never experienced 30 per cent growth in the past; nor has any other country for that matter, at least not for any sustained period of time," said Maholopa Laveil, a lecturer in economics at the University of Papua New Guinea.

Figure 10: Safety History



Source: Oil Search PNG Field Trip Presentation – November 2019

To reach his lofty goal, Marape appears to be betting on a surge in gas revenues and more of that cash staying in the country.

While the goal stated in his maiden speech is highly dubious, it is clear he has little room to move and has few alternatives other than bedding down commercial terms that are on offer.

If Marape is to fulfil his 10-year promise, he must strike a commercial deal rather than alienate international financiers. As noted previously, social unrest is a likely consequence if he is to play hard ball with listed public entities whose governance regimes are unbending. We understand that demands from consultants enlisted by the government are wide of the mark at best, in terms of being commercially palatable, and at worst naïve.

At first glance the trajectory pictured in Figure 10 looks wrong. We sought an opinion from straight-shooting long-term Oil Search employee, PNG national and SVP of Exploration and Operations Shane Schofield.

Schofield explained that two thirds of safety incidents are generated by the infield seismic teams where the following factors are at play:

- Oil Search has a preference to employ locals in their local territories, where possible.
- Machete usage is the typical approach to clearing rainforest.
- Historically locals have not worn shoes or protective gear in the field.

The combination of these elements is the key challenge for the Oil Search safety culture, which is measured against a global benchmark.

Schofield noted that many of these safety events are minor but require reporting under the comprehensive company-wide safety protocols. While this explanation makes sense, it is certainly something to watch in the future.

We gained a bird's eye (helicopter) view of the near impossible task, that is a seismic survey of the PNG highlands.

In this season alone, 118km of 2D seismic will be shot. This project will involve 700 people, across 32 field camps, at a cost of US$300,000 per km. As the cost of 3D is prohibited in these regions, the program is 2D only. This requires the clearing of a single line of rainforest that is then drilled. Seismic is then shot into the holes, which is followed by a green team who clean up and rehabilitate the environment.

Figure 11: Extract from PNG OSH Organisational Chart

Source: Oil Search PNG Field Trip Presentation – November 2019

All up this is a labour-intensive process in some of the most spectacularly hostile working environments on the planet. There is a reason why the Kokoda trail remains one of the world's most challenging and dangerous adventure trails.

3D is a quantum leap in the information produced, but requires significant additional clearing as a grid pattern is used, picking up data from features which impact the areas around the seismic lines.

It would also be less effective here due to limestone caves and sink holes, which dot the region as a result of distortions created by energy loss in these unique topographies.

New local leadership for Oil Search in PNG

The leadership transition from Peter Botten to designated CEO Keiran Wulff has been well publicised. Less has been said about the in-country relationship management. The responsibility here passes to SVP External Affairs and Government, Wayne Kasou and SVP External Affairs and Community, Leon Buskens both pictured in Figure 11. While we have not met either of these individuals, our understanding is that both executives have strong government relationships, with Prime Minister Marape (amongst others), which can be traced back to schoolboy days.

Relationships are important and we are big believers that having strong, capable local leadership will lead to a more sustainable solution, as opposed to a continuous merry go round of expat leaders.

Alaska, a Material Development

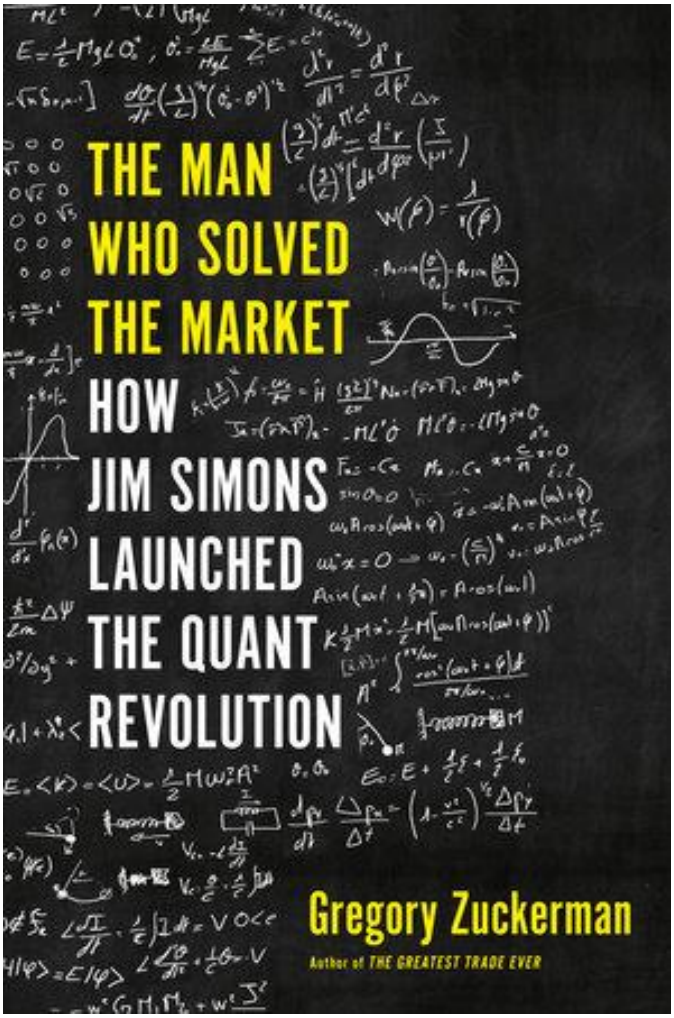
On the 18 December, Oil Search approved entry into the Front End Engineering and Design (FEED) phase of the Pikka Unit Development on the North Slope of Alaska. They also provided a 2C contingent oil resource upgrade to 728mmboe, representing a 46% increase on the 2C contingent acquisition case of 500mmboe.

This is largely in line with the expectations we developed when we travelled to Alaska a little over 12 months ago. One change we note is that funding of projects on the North Slope has become more difficult and U.S. banks have clearly shied away from involvement in any controversial or environmentally sensitive exposures.

The implications for Oil Search are that funding may have to be sought at a corporate level rather than at a project level, which runs greater risk of scrutiny from increasingly climate aware shareholders and other stakeholders within broader communities. ***SFM***

HOLIDAY BOOK REVIEW

Figure 12: The man who solved the market



Source: Zuckerman G. (2019). The Man Who Solved the Market: How Jim Simons Launched the Quant Revolution. Penguin Random house.

This is a worthy holiday read. It profiles Jim Simons who is the world acclaimed geometer, founder of Renaissance Technologies (Medallion Fund) and owner of arguably one of the best track records on Wall Street. That very track record, from the late nineties onwards, reflects Simons' success in applying statistical analysis to financial markets.

Yet the book is more than a recount of Simons' life, covering both the modern history of markets and the emergence of math-based machine learning that developed simultaneously in the bowels of government and the iconic U.S. technology corporations of the day.

Zuckerman's journey chronicles how IBM initially focused on deep learning as a marketing avenue. Peter Brown, Head of IBM's computer linguistics department at the time, figured the publicity generated by developing a machine capable of beating the then Russian chess world champion was a cheaper alternative than advertising during the NFL Super bowl, a tactic that had been successfully adopted by Apple in the early 80's. Brown along with Mercer, his former partner at IBM, go on to become key architects of the Medallion Fund's successful transition from futures trading to the broader and deeper pools of global equities markets.

In considering the return profile generated by Simons, we found the following extract to be amongst the most revealing passages of the book. In three short paragraphs Zuckerman uncovers the amazing leverage that Renaissance swings into its high frequency trading, while exposing some of the more frightening risk management profiles of modern global banking. This is a key reason we have never owned a bank stock, a combination of leverage and the low transparency of the loan books that are buried in their vaults.

"The basket options were a crafty way to supercharge Medallion's returns. Brokerage and other restrictions place limits on how much a hedge fund can borrow through more traditional loans, but the options gave Medallion the ability to borrow significantly more than it otherwise was allowed to. Competitors generally had about seven dollars of financial instruments for each dollar of cash. By contrast, Medallion's options strategy allowed it to have $12.50 worth of financial instruments for every dollar of cash, making it easier to trounce the rivals, assuming it could keep finding profitable trades. When Medallion spied especially juicy opportunities, such as during a 2002 market downturn, the fund could boost its leverage, holding close to $20 of assets for each dollar of cash, effectively placing the portfolio on steroids. In 2002, Medallion managed over $5 billion, but it controlled more than $60 billion of investment positions, thanks in part to the options helping the fund score a gain of 25.8 percent despite a tough year for the broader market. (The S&P 500 lost 22.1 percent in 2002, a year marked by the bankruptcies of internet companies and reverberations for the collapse of the trading and company Enron and the telecommunications giant WorldCom.)

The options also were a way of shifting enormous risk from Renaissance to the banks. Because the lenders technically owned the underlying securities in the basket-options transactions, the most Medallion could lose in the event of a sudden collapse was the premium it has paid for the options and the collateral held by the banks. That amounted to several hundred million dollars. By contrast, the banks faced billions of dollars of potential losses if Medallion were to experience deep troubles. In the words of a banker involved in the lending arrangement, the options allowed Medallion to 'ring-fence' its stock portfolios, protecting other parts of the firm, including Laufer's still-thriving futures trading, and ensuring Renaissance's survival in the event something unforeseen took place. One staffer was so shocked by the terms of the financing that he shifted most of his life savings into Medallion, realizing the most he could lose was about 20 percent of his money.

The banks embraced the serious risk despite having ample reason to be wary. For one thing, they had no clue why Medallion's strategies worked. And the fund only had a decade of impressive returns. In addition, Long Term Capital Management had imploded just a few years earlier, providing a stark lesson regarding the danger of relying on murky models."

This book will stimulate debate. Two from our office have finished the book and we both concur that on completion we have a slightly diminished view of the founder Jim Simons. It's a simplistic one-sided assessment. Simons has not endorsed or approved of this account. That said, the ethics of some decisions made are questionable. The desire to raise a $100b fund for no other reason than to be the largest does not sit comfortably with us. Nor do the very sharp tax practices and the poor culture of the firm.

Interestingly, while carrying a copy of the book, we bumped into the Chief Investment Officer of a leading (performance-wise) Industry Super Fund and he explained how he visited the offices of Renaissance. After meeting representatives of the firm and hearing presentations, he could not understand what they did nor how they generated returns. He found it impossible to consider an investment.

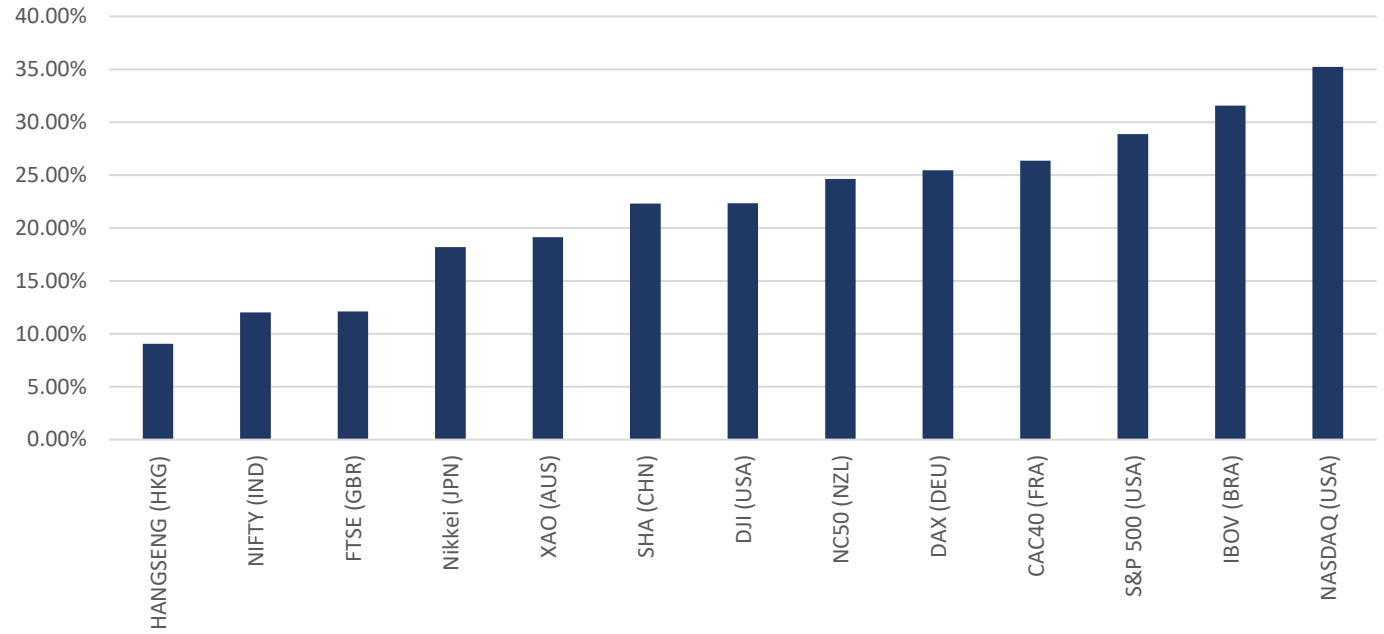
Based on the ongoing tax investigations[11], this may well be the strategy others wish they adopted. We leave you with a question to ponder over – what is the purpose of our global financial markets as we know them, and should society have ethical concerns about how they are used? ***SFM***

[11] *Source: Rubin, G. (2019). WSJ News Exclusive | Renaissance Employees Could Face Clawbacks Over Hedge Fund's Tax Maneuver. [online] WSJ. Available at: https://www.wsj.com/articles/renaissance-employees-could-face-clawbacks-over-hedge-funds-tax-maneuver-11576679101 [Accessed 19 Dec. 2019].*

2019 GLOBAL MARKET INDEX PERFORMANCE

In a calendar year impeded with global uncertainty and unrest, international markets delivered significant positive performance, averaging 22% growth across 13 indexes as seen in Chart 7 below.

Chart 7: Global Market Index Performance for Calendar Year 2019



Source: IRESS Market Technologies

Interestingly, the uncertainties surrounding the U.S.-China Trade war have appeared to have had minimal impact on the U.S. market's performance, with the NASDAQ reaching highs of 9,000 on 26 December. Overall, the NASDAQ was the best performer, rising 35.2% for the 2019 calendar year.

In contrast, the ongoing Hong Kong protests, stretching back to March this year have acted as a significant detractor to their market's performance, recording a muted rise of 9.1%. This compares to China's Shanghai Composite Index which delivered a gain of 22.3%.

COMPANY VISIT DIARY – DECEMBER 2019 QUARTER

Date	Company	Description
1-Oct	LME	Limeaid Non-deal roadshow at Macquarie
2-Oct	IPD	Impedimed Conference Call with Board
10-Oct	DMP	Domino's Pizza Enterprises Brisbane Investor Day
15-Oct	N/A	Property Guru Management Roadshow at UBS
16-Oct	CSL	CSL Annual General Meeting
17-Oct	OPT	Opthea GS Management Meeting
21-Oct	SEK	SEEK SFML Management Meeting with Chair
22-Oct	COH	Cochlear Annual General Meeting
24-Oct	WEB	Webjet GS Annual Tech Day Management Meeting
24-Oct	EML	EML Payments GS Annual Tech Day Management Meeting
24-Oct	Z1P	Zip Co GS Annual Tech Day Management Meeting
24-Oct	ISX	iSignthis GS Annual Tech Day Management Meeting
24-Oct	DMP	Domino's Pizza Enterprises GS Annual Tech Day Management Meeting
24-Oct	DUB	Dubber GS Annual Tech Day Management Meeting
24-Oct	CTD	Corporate Travel Management GS Annual Tech Day Management Meeting
24-Oct	TNE	TechnologyOne GS Annual Tech Day Management Meeting
24-Oct	MP1	Megaport GS Annual Tech Day Management Meeting
24-Oct	IFM	Infomedia GS Annual Tech Day Management Meeting
24-Oct	AD8	Audinate GS Annual Tech Day Management Meeting
24-Oct	DMP	Domino's Pizza Enterprises SFML Management Meeting at GS
24-Oct	MP1	Megaport SFML Management Meeting at GS
24-Oct	IFM	Infomedia SFML Management Meeting at GS
24-Oct	RMD	ResMed 1Q FY20 Results Conference Call
24-Oct	MP1	Megaport GS Management lunch
28-Oct	IRE	IRESS GS Management Meeting
30-Oct	IPD	Impedimed 1Q FY20 Results Conference Call
31-Oct	IFM	Infomedia Annual General Meeting
31-Oct	RWC	Reliance Worldwide Annual General Meeting
31-Oct	BKL	Blackmores Annual General Meeting
4-Nov	SGM	Sims Metal Management SFML Management Meeting with Investor Relations
6-Nov	MPL	Medibank Private FY20 Outlook Update Call
7-Nov	JHX	James Hardie Industries 2Q FY20 Results Conference Call
7-Nov	JHX	James Hardie Industries Morgan Stanley Management Meeting
7-Nov	JHX	James Hardie Industries Results Dinner Meeting
7-Nov	SGM	Sims Metal Management Management Meeting with Chair
11-Nov	IPD	Impedimed SFML Management Meeting
12-Nov	IPD	Impedimed Annual General Meeting
12-Nov	OFX	OFX Group 1H20 Results Conference Call
12-Nov	IFL	IOOF Holdings SFML Management Meeting with Chair
12-Nov	JHX	James Hardie Industries SFML Management Meeting
12-Nov	NAN	Nanosonics GS Management Meeting
13-Nov	OFX	OFX Group SFML Management Meeting

Date	Company	Description
13-Nov	CPU	Computershare Annual General Meeting
13-Nov	OFX	OFX Group UBS Management Meeting
13-Nov	NAN	Nanosonics SFML Management Meeting with Board
13-Nov	VEE	VEEM Morgans Management Meeting
14-Nov	NEA	Nearmap Annual General Meeting
14-Nov	TLX	Telix Pharmaceuticals SFML Management Meeting
15-Nov	51Job.NAS	51Job.NAS 3Q19 Results Conference Call
15-Nov	PNV	PolyNovo Annual General Meeting
15-Nov	SGM	Sims Metal Management JPMorgan Management Meeting
18-Nov	NAN	Nanosonics Annual General Meeting
19-Nov	TNE	TechnologyOne FY19 Results Conference Call
20-Nov	SKO	Serko 1H20 Results Conference Call
20-Nov	ALL	Aristocrat Leisure FY19 Results Conference Call
20-Nov	TNE	TechnologyOne SFML Management Meeting
21-Nov	N/A	SPIRE Macquarie Non-Deal Roadshow
21-Nov	ALL	Aristocrat Leisure UBS Management Meeting
25-Nov	APX	Appen SFML Management Meeting
26-Nov	BRG	Breville Macquarie Emerging Leaders Forum Management Meeting
27-Nov	JIN	Jumbo Interactive Macquarie Emerging Leaders Forum Management Meeting
27-Nov	NEA	Nearmap Macquarie Emerging Leaders Forum Management Meeting
27-Nov	FPH	Fisher & Paykel Healthcare 1H20 Results Conference Call
27-Nov	NEA	Nearmap GS Management Meeting
27-Nov	ALL	Aristocrat Leisure SFML Management Meeting
28-Nov	IFL	IOOF Holdings Annual General Meeting
28-Nov	N/A	Centric UBS Management Meeting
2-Dec	FPH	Fisher & Paykel Healthcare SFML Management Meeting
2-Dec	FPH	Fisher & Paykel Healthcare GS Management Meeting
3-Dec	FPH	Fisher & Paykel Healthcare GS Management Meeting
4-Dec	CSL	CSL Annual Research & Development Briefing
5-Dec	SGM	Sims Metal Management Meeting with CFO
5-Dec	MP1	Megaport Capital Raising Conference Call
6-Dec	ALU	Altium Technology Day
6-Dec	ALU	Altium Annual General Meeting
6-Dec	NHF	NIB Holdings Investor conference Call
9-Dec	BKL	Blackmores SFML Management Meeting
10-Dec	FCL	Fineos SFML Meeting with Chair
13-Dec	FBR	FBR Limited Company Briefing
17-Dec	PNV	PolyNovo SFML Conference Call
18-Dec	PXS	Pharmaxis Investor Conference Call

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