Airlie Australian Small Companies Fund Quarterly Update

April 2024

Jack Mann:

Hello, and welcome to this quarterly update for the Airlie Small Companies Fund. My name is Jack Mann. I'm part of the Magellan distribution team. Today, I'm joined by Portfolio Manager Will Granger. Welcome, Will.

Will Granger:

Thanks for having me.

Jack Mann:

It's been a year since you launched the fund. You've done a stellar job, 22% returns since inception, which is about a 9% return above the index. Can you talk us through some of your contributors?

Will Granger:

Yeah, look, we are really pleased with the start to the fund. It's great to get off to a good start. Pleasantly, performance has come from a wide array of stocks in the portfolio. I think to put some numbers around that, we've actually had 11 stocks contribute more than 1% to gross performance, and just two stocks contribute more than negative 1% to gross performance. I guess to summarize that, performance has really come across the board with only a small subset of material detractors.

There were a few names in there that were standouts, that are probably worth mentioning. Gentrack for one. For those who don't know, that's a software business, a tech business that sells enterprise software to utilities and airports around the globe. We really like these types of businesses that sell mission-critical enterprise software. Because typically they come with really low customer churn, given how difficult and costly it can be to switch providers. That low churn then creates very predictable annuity style revenues.

Prior to our purchase, Gentrack had gone through a rough couple of years. There were some customer closures in the UK related to regulatory issues that had really dampened the margins. We looked at those issues, thought they were mostly temporary, and added to our position on signs of improving underlying revenue growth as well as some recovery in those margins. Now, the stock's gone on a great run since. It's certainly not as cheap as it was 6 or 12 months ago. But I think the important thing to note with Gentrack is just how long the runway is there, as utility customers continue to upgrade systems to account for the ever-changing demands of the energy transition, and as those profit margins recover towards more historical levels. We're still optimistic about that one, despite the run.

The other strong performer that's worth noting has been News Corp. It's been a core position in the fund since inception. Really, the thesis there centered around the Dow Jones business, which has undergone this enormous transformation over the last decade. They've transitioned away from the adreliant model to one that focuses on maximizing digital subscriptions. That transformation has vastly improved the quality of the business. We thought the market had largely overlooked that.

Now, recent results in Dow Jones have been very strong. We think the market's now starting to attribute a more reasonable valuation to that segment. Those were two of the key winners. If we look on the other side of the ledger, Tabcorp's been the most material detractor from performance. It's an interesting one because operationally, Tabcorp's actually performed okay. They've achieved some milestones in terms of leveling the playing field with some of their online bookmaker competitors, but the stocks really struggled against the backdrop of a really soft wagering market. We'd probably underestimated how much the business was over earning due to the COVID-related boom in wagering. But fortunately, the stock is cheaper. It's trading on around 10 times free cash flow, so we remain patient holders.

There are a few of the key contributors. I would say though, whilst it's great to have some good numbers in your first year, we really don't like to focus too much on performance in any given year. Performance of the short term can be quite volatile. It's often more correlated with market sentiment than it is underlying business fundamentals. When we're investing, we're really thinking about businesses on a three-to-five-year view. I think our performance is best judged over a similar timeframe.

While I'd caution investors from taking too much comfort in any given year's numbers, what I do think they can take comfort in is the fact that I'm invested alongside them.

Jack Mann:

Yeah, awesome. You talked about some really interesting businesses. But I think probably more importantly some very different businesses as well. If you reflect on the last, say, 12 months or since inception for yourself, can you talk about some of the themes that you think have been driving the small cap market?

Will Granger:

Yeah. If I had to pick one single theme that I think has been quite interesting over the last 12 months, it's probably been the resilience of the consumer. Who would've guessed that many retailers today would be making record or close to record profits and margins after such a rapid rise in interest rates and other cost of living pressures? That resilience has certainly exceeded my expectations. I think there is a good lesson there in terms of just how unpredictable the macro can be.

The funds held some material weightings in the retail sector, namely Premier Investments and Nick Scali. But to be clear, those theses were never predicated on any special insight into the macro, but rather an insight into the resilience of their business models, their stellar management, and their fortress-like balance sheets. All of which would allow those businesses not only to endure the worst downturn in consumer spending, but to emerge at the other side in a stronger competitive position.

I think it's also interesting to note just how volatile valuations have been in retail over the last 12 months. You take those two examples, Premier and Nick Scali, those two stocks are up 60 and 85% off their lows set in just June last year. That's an enormous change in valuation in a really short period of time, that surely doesn't reflect a commensurate change in intrinsic value. I think therein lies the opportunity for active managers. We love that volatility because it throws up these opportunities to go and buy these really high-quality businesses at attractive prices.

The other thing I'd note is, if you look at the fund's performance itself, and we rewind back to first quarter of last year, those retailers were actually our worst performers. They are material drag on performance for the fund. Fast forward to today, collectively, they're our best performers in the fund.

I think that well illustrates the issue with focusing too much on short-term performance that we talked about earlier. Had we been really concerned about putting out some good short-term numbers, then perhaps we wouldn't have taken a position in those retailers, which would've been to the detriment of performance.

Now, to be clear, I don't think the retailers are out of the woods just yet. It's far too early to declare victory there. But I do think this demonstrates one of the key issues with short-termism. It's why we're so keen on finding investors who share our long-term mindset for investing, who understand the philosophy of the fund, will afford us the latitude to go and take a long-term view in markets. Yeah.

Jack Mann:

You talk about how retailers have gone on a bit of a tear, but really, if you look at the whole small odds index over the last six months, I think it's up, let's say close to 16%. How are you finding markets at the moment? Are you still able to find opportunities?

Will Granger:

Yeah, look, it's definitely harder than it was. The market's gone on quite a tear. Valuation's just as unattractive as they were six months ago. But I think the beauty of the fund is that we've got a very broad mandate. The small cap universe, our investment universe, it's a very deep universe. There's plenty of opportunities to uncover out there. Airlie, for several years, the team has been investing in small caps. We've got a robust process of applying our process, going and finding these really nascent high-quality businesses. I think we can keep continuing to do that. I'm very optimistic about the fund's future prospects.

Jack Mann:

Thanks, Will. Thanks very much for joining us. Please feel free to share this with any of your clients.

Important Information