Airlie Quarterly Update

January 2024

Felicity Haines:

Hello and welcome to this quarterly update for the Airlie Australian Share Fund. My name is Felicity Haines. I'm a key account manager with Magellan. And today I am talking to Emma Fisher, deputy head of Australian Equities at Airlie and portfolio manager of the. Airlie Australian Share Fund. Hi Emma.

Emma Fischer:

Hi.

Felicity Haines:

Thanks for joining me.

Emma Fischer:

Thank you for having me.

Felicity Haines:

Great year for you and the team, so congratulations on that. In terms of Australian equities, can you give us a summary of the year that was 2023?

Emma Fischer:

Yeah, look, I think when it comes to markets, if I had to sum the year up in a word, actually it's not even a word, it's a sound. It would be like [inaudible 00:00:54], like that. The market actually, to October, was flat from a share price perspective, and all of the return has come in this extraordinary rally that we've seen in November and December. And so the market as a whole has posted a really solid year with a return of 12.4%. The Airlie Australian Share Fund has had a great year, as you mentioned, returning 15.4% net of fees.

So the themes, I guess, or really what's driven that, I think, there's... two I'd call out. So the first is, and I think this time a year ago we were really saying this, the market really got very over its skis in baking in quite a high proportion chance of a recession, of a global recession. And what that was doing was throwing off great opportunities to buy high quality businesses where no one wanted to touch them because they were worried about the cycle. I think the obvious example there would be James Hardie. If you look at the ASX 100, the number one performing stock in the 100 is James Hardie, which was up 118% this year. The number two best performing stock was Seven Group, which is up 75% this year. Now we own both of these. They've been long-term large positions in the fund, and I think they're both examples of businesses that a year ago were just too cheap because everyone was far too concerned about the cycle.

The second thematic I'd call out over 2023 that's really helped the portfolio has been the resilience of the Australian consumer. I have read so much talk about this mortgage cliff that was going to lead to so much stress and so much forced selling of housing, basically Armageddon for the housing market, and it just hasn't come to fruition. And we've seen that in the extraordinary resilience of consumers, and I think it comes down to employment. Everyone has a job. They've probably just received the largest pay rise that, from a percentage change perspective, that they've gotten in a very long time. And so basically the economy has been able to bear these higher interest rates.

So those two thematics have really played out over the year and have driven quite a strong return for the markets as a whole and for the fund.

Felicity Haines:

So with that in mind, what were the additions and disposals within the portfolio and can you tell us what prompted the changes?

Emma Fischer:

Yeah, so it's funny, we actually didn't this year add a huge amount of new positions. Really in terms of changes, what we've been doing has been trimming and adding, and broadly I categorize a lot of our trimming has been businesses that have really worked for us over the year. And so when we put something like a Hardie's or a Seven Group through our process today, the first three parts of our process, balance sheet, management quality, business quality, they all still look very positive. But now that these businesses have performed very well, that valuation piece looks less compelling. Now what that means, I guess is, mathematically, your future returns are going to be lower, and as a result we've reduced our position size in some of those businesses. News Corp will be another one that I'd throw out as sort of a sleepy performer. It's had a very good year and it was a large position for us. So we've reduced our weight in that slightly.

Now what we've been adding to on the other side has been some of the dogs in the portfolio. Not everything works. Not everything has worked for us and some of the ones that haven't have included Tabcorp. They have recently renegotiated with the Victorian government for an extension of their wagering license, and I think that's a really key part of our thesis, which is that they're able to level the playing field in all of their key wagering states. So we think that's good news and we've been adding to that position as we just think it's too cheap. But that definitely was a detractor over 2023.

And then the other one in that same camp would be Orora. The market hated the acquisition of Saverglass, which was a large acquisition that came very much out of left field, and it gave them a lot of global exposure to luxury spirits, and they did themselves no favors with their timing of that because they basically walked straight into a consumer destocking cycle with global luxury spirit demand falling. We think at $2.60, the current share price, that that's pricing in a lot of this negativity and certainly we see a lot of these factors as short term. And the work that we've done, talking to a lot of people that understand the Saverglass business, that have worked there or competitors, that leads us to think it's a pretty solid business and I don't think that they paid a dramatically crazy price for it. So we think that the Risk/Reward is actually very attractive down here, so that's one that we've been adding to.

In terms of wholesale new additions to the portfolio, the only one that really is meaningful would be ResMed. We haven't owned ResMed since the inception of the fund. We've always really liked it, but that valuation piece has been very uncompelling for us. The business, very high quality. It traded on 35 to 40 times earnings for a number of years. The opportunity to add it to the fund has come this year as it's been swept up in this debate around whether or not GLP-1s, which most people know as sort of

Ozempic, whether or not these class of drugs is going to effectively cure obesity. Why that matters for ResMed is sleep apnea, which they treat with their CPAP devices, is highly correlated to obesity. The fatter you are, basically, the worst your sleep apnea usually is. So there's a view that if you reduce obesity rates, you're actually destroying the addressable market for ResMed. Now, we believe that view was more than mispriced into the share price. The stock had fallen from $32 to $21 at one point. We definitely went a bit early, but we were adding a lot on the way down and we've now ended up with a very large position in ResMed, and that's been more helpful than not, I guess, over the last couple of months.

In terms of wholesale exits, we owned Region Group, which is a neighborhood shopping center business, and we have exited that and recycled the proceeds into Waypoint REIT, which we've also owned for a number of years. We didn't want to reduce our overall REIT exposure, but when we put these two businesses head to head, we felt that Waypoint REIT had much better inflation protection in its rent structure than Region Group did.

Felicity Haines:

Emma, the factors that you look at to assess the company have worked for a long time now, and you mentioned ResMed a moment ago and the large position that you have there. Can you talk us through how you think about position sizing?

Emma Fischer:

Yeah, so as a refresher, so our process, we start with the balance sheet and then we're assessing business quality, management quality, and valuation. So those are the four factors that we look at. And the reality of how that flows into a portfolio is... I always think of it in my head as a bit of a traffic light system. So if you see green lights across all of those factors, you want to take a large position in that.

It's actually very rare to see green lights across every one of those factors. It's got to be a green light for the balance sheet for us to proceed. But the reality is with the other three factors, investing is all about trade-offs. So when you don't have to make any trade-offs, and it's really attractive across all of them, like in a situation with how we consider ResMed right now, our experience suggests to us that that's when you want to take a large position. So for us, a large position is around 5%, which would be our position in ResMed.

The next level down in terms of position sizing is usually when you can identify what trade-off you're making. So for example, maybe the business quality isn't where you think it should be, but you can see a path there, and that would be Tabcorp, for example. It's a turnaround story. We think the business quality can improve and we think that we're being more than compensated in the valuation. But because turnarounds are risky, you're not going to have your maximum position size in that business. So that's more of like a 2% position.

Felicity Haines:

And now onto the year ahead, what's your outlook for 2024?

Emma Fischer:

I think my outlook any year is that you're going to find opportunities to find mispriced businesses. That's always going to be my starting point. What's different about this year versus maybe the last couple of years is that the last few years, this enormous macro focus of the markets and the volatility that that's thrown off have given you a lot of opportunities in businesses where everyone's just worried about the cycle. That's what's presented... We've seen whole sectors thrown out. Retail sector, no one wants to touch it. REIT sector, no wants to touch it. Builders a year ago, no one wanted to touch them. So you saw whole sectors thrown out because of fears around certain cyclical exposure.

Given the rerate that a lot of those businesses have had... And you can see it in the ASX. We're basically back to all time highs... I don't think you can see those wholesale sector wide opportunities... Where now you see the opportunity... It's sort of going back to 2019, 2018, 2017, a normal period for stock pickers where it's just bottom up. It's a good business, has a hiccup, that sort of thing. Now we've got a couple of... I think the market broadly looks on the fuller side of fair. I wouldn't say that ideas are falling out of the trees for us, but there are a few businesses that we're doing a lot of work on that we think fall into that category of high quality businesses where something in the short term has gone wrong and perhaps the business has been oversold. So I can't really talk too much about things that we haven't added to the portfolio yet, but there are some things we think that are coming our way.

Felicity Haines:

Thanks, Emma.

Emma Fischer:

Thank you for having me.

Felicity Haines:

And thanks for watching. If you have any further questions, please contact my colleagues and I in the Magellan distribution team and please feel free to share this video with any clients and colleagues.