AVENIR
CAPITAL

31st January 2020

Dear Partner:

The Avenir Global Fund (the “Fund”) performed strongly during the December 2019 quarter, increasing 13.2% (net) compared to the MSCI ACWI index (in AUD) which increased by 4.5%[1]. Over the past year, the Fund has increased 20.3% (net) compared to the MSCI ACWI index (in AUD) which returned 26.8%[1]. Since inception of the Fund over nine years ago, the investment strategy has delivered 13.8% per annum[2]. Our goal continues to be to deliver strong, risk-adjusted, absolute returns over the medium-to-long term.

Market Commentary

2019 was a very strong year for equities with the broad market increasing by 26.8%[3]. Using the S&P 500 as a proxy, 2019 was the tenth largest year for equity returns since 1929. But, it was a year in which the vast bulk of the market gains were driven by multiple expansion, with the trailing price-to-earnings (PE) ratio going from 19x to 25x and the forward PE ratio expanding from 15x to 19x[4].

This multiple expansion was most pronounced in so-called growth stocks, although value-oriented names benefitted as well. According to recent research by O’Shaughnessy Asset Management (OSAM) (a U.S. quantitative fund), value stocks delivered better fundamental performance than growth stocks in 2019, in terms of earnings growth and return of capital (dividends and buybacks), but the massive multiple expansion in the growth part of the market still saw growth outperform value for the year[5].

Furthermore, OSAM point out that the widening valuation spread between the cheap and expensive segments of the market is based on increased optimism about the future earnings prospects of growth stocks (despite the poor fundamental performance in 2019) and decreased optimism about the future earnings prospects of value-oriented stocks. According to OSAM, the average sell side analyst’s estimate for long-term earnings growth for growth stocks, as collected by IBES[6], is now about 20% per year, and, for value companies, the corresponding figure is about 7% per year. The spread between the two is close to 12% per annum and is very close to matching the relative optimism around growth stocks over value stocks that existed in the March 2000 ‘dotcom’ extreme (about a 13% spread then).

In other words, analysts have the second highest expectations for earnings for growth stocks, in absolute terms and relative to value, since 2000.

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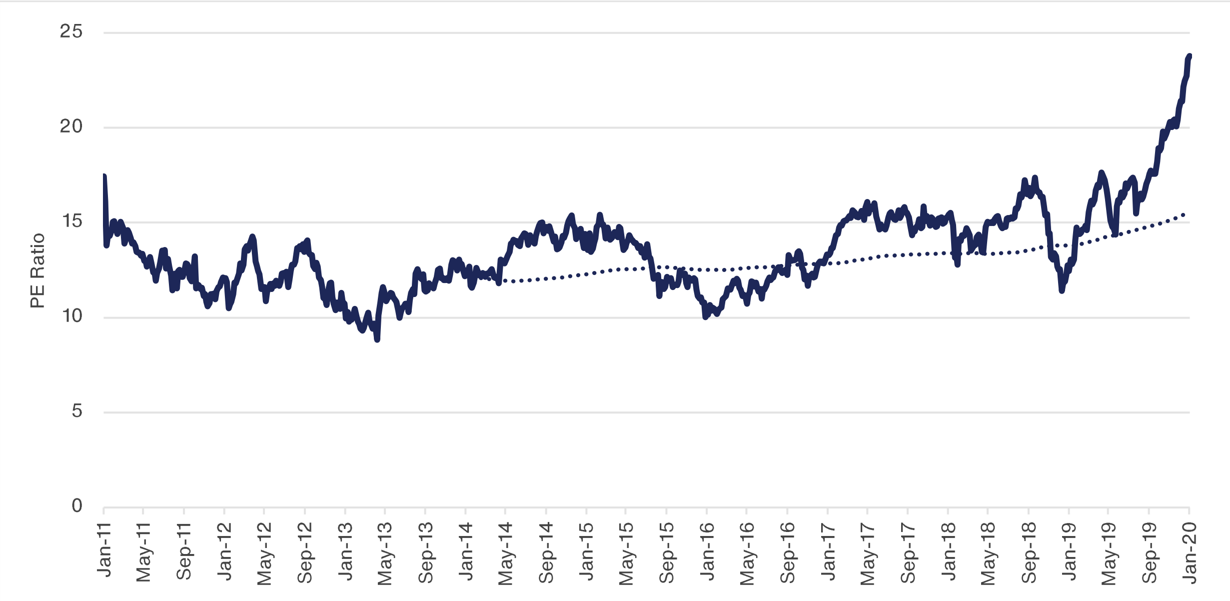
1 Performance figures refer to the Avenir Global Fund – Class A launched on 25 August 2017. Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. For full performance figures please see our website at www.avenircapital.com.au. Past performance is not a reliable indicator of future performance.
2 For informational purposes and to give a longer-term view of the track record of the Fund’s investment strategy, the historical returns quoted here are those of Class I of the Fund since its inception date of August 2011 and are represented on a net of fees basis whereby returns are adjusted to deduct the fees applicable to Class A as if applied throughout the performance period since the inception of Class I (noting that Class I performance fees have been calculated on the basis of monthly returns rather than daily returns applicable to Class A). Returns assume distributions have been reinvested and no allowance is made for tax when calculating these figures. The investment guidelines, process, methodology and universe of Classes A and I are identical. Past performance is not a reliable indicator of future performance.
3 MSCI ACWI index (in AUD)
4 Capital IQ; Avenir Analysis
5 O’Shaughnessy Asset Management Quarterly Investor Letter Q4 2019;
https://osam.com/pdfs/research/Q4%202019%20Investor%20Letter%20-%20FINAL.pdf
6 IBES is the Institutional Brokers Estimate System and is a database that gathers and compiles the different estimates made by stock analysts on the future earnings of publicly traded companies.

For what it's worth, the market is now trading almost two standard deviations above its ten-year average multiple. The CAPE ratio[7] for US large cap stocks is currently 30.8x, which is in the 96th percentile of expensive and well above the median of 16.2x.

For some individual companies, the rerating has been even more extreme. Take Apple, for example, which for the past decade has typically traded at roughly a 20% discount to the broader market (about 14x forward PE). The rally in Apple stock in 2019 added about US$560 billion of market capitalization to Apple alone. To put that in perspective, that's almost 40% of the market capitalization of the entire Australian stock market. Now trading on 24x forward PE, which is arguably not extreme compared to some of its tech peers, Apple is almost 4 standard deviations more expensive than its ten-year average. Apple is a very high-quality company, but its recent share price performance raises questions as to what has changed in the last year to give investors more confidence in Apple's prospects than at any point in the past decade.

Chart 1: Apple Forward Price-to-Earnings Ratio

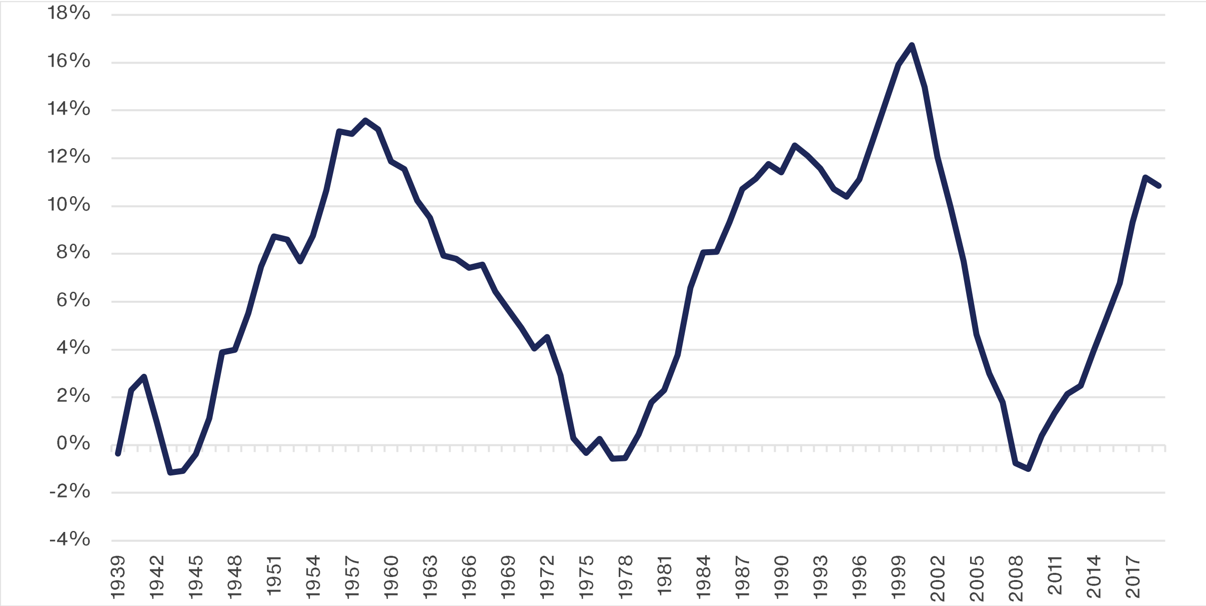


Source: Capital IQ; Avenir Analysis

Over the longer run, 2019 capped off a strong decade for markets too. Trailing decadal returns (i.e. annualised returns for the last ten years) were 11% at the end of 2019, coming close to some of the biggest bull markets of the last century, and this result is flattered even more once the low inflation environment is considered.

7 Also known as the Shiller P/E ratio, the Cyclically-Adjusted Price-to-Earnings ratio (CAPE) is a measure of price divided by a 10-year average of earnings, all adjusted for inflation. The objective of the CAPE is to smooth out fluctuations in corporate profits that occur over different periods of a business cycle. Data for the CAPE Ratio here is provided by Research Affiliates; interactive.researchaffiliates.com/asset-allocation

Chart 2: S&P 500 Rolling 10-Year Returns Annualised



Source: Capital IQ; Avenir Analysis

While it would be foolish to make predictions on the next twelve months based on these observations, market multiples are elevated and earnings growth is lacking the exogenous boosts that played a large role in driving recent earnings growth such as the large corporate tax cuts in the U.S. that helped drive strong U.S. corporate earnings gains in 2018. Keeping one eye on these increasing signs of exuberance in some markets, especially in the face of ongoing Middle East tension and trade friction between the U.S. and China, we are focusing more of our idea search outside of the relatively expensive North American market.

To illustrate the potentially richer pickings in non-U.S. parts of the world, the CAPE ratio for emerging markets is currently 13.4x (compared to the median of 15.4x and in the 28th percentile of expensive), while EAFE[8] markets are currently at 17.3x (compared to the median of 24.6x and in the 36th percentile of expensive).

By investing in a patiently and carefully selected portfolio of what we consider to be high quality and growing, but mispriced companies, we aim to construct a portfolio that can compound in value over time without requiring a strong market to 'lift all boats'. Whilst the past decade has provided one of the most helpful market tailwinds ever seen (certainly in the US), it is probably too much to expect that the next decade will be as friendly.

As chart 2 above shows, good times for the overall market can be followed by bad. The market moves in cycles and will continue to do so. Our job is not to try to predict future long-term equity market returns, but to position our portfolio in a manner that provides robust downside protection and the prospect for attractive returns over the medium-to-long term regardless of overall market performance.

8 EAFE is based on the MSCI EAFE index and refers to large and mid-cap companies in 21 developed markets including Europe. Australasia and the Far East and excluding the US and Canada.

As importantly, we run a concentrated portfolio of best ideas that we believe provides a very different exposure for our investors than simple exposure to the overall markets. Our Active Share is over 99, highlighting how different we are from the index, or 'the market'. Active Share is a measure that reflects how different a portfolio is from an index where an Active Share of 0 reflects a portfolio that is exactly the same as the index, and an Active Share of 100 reflects a portfolio that is as different from the index as you can be.

Our returns since inception have been generated without owning the megacap US stocks that people are familiar with and that have played such a large role in driving overall market performance over the past decade, such as Facebook, Apple, Alphabet, Microsoft, Netflix, etc. Not to say that we would never own shares in these companies, and they are wonderful companies, but we believe we can play a useful role for our investors in providing exposure to companies that are different from those they will be exposed to via passive index based products, or, indeed, that populate the portfolio of many global equity funds in an increasingly crowded investment space.

Speaking of our portfolio, our healthy gains for the year were driven by the idiosyncratic results of the individual investments in our concentrated, best ideas portfolio.

Select Portfolio Updates

Our best performing investment in the December quarter was Dart Group, based in the UK, which increased in price by 85%. Dart was also our best performer for all of 2019, increasing by 121% over the year. Dart is a UK-based airline and tour holiday operator, which we have owned since the beginning of 2018, which offered growth, high returns on capital and high customer loyalty to their value-for-money holiday packages. Despite these characteristics, it was trading on a single-digit PE multiple, in part, due to the overhang of Brexit.

Dart has been steadily gaining market share under the focused leadership of 31% shareholder, Philip Meeson. Meeson is the kind of owner-operator that we enjoy partnering with in investments as we have great confidence in their abilities, due to their demonstrated track record in creating value, and our interests are well aligned due to their meaningful equity ownership. Over the past 10-years, the share price of Dart has increased by 38x as the company's competitive position has increased enormously under Meeson's astute leadership. Sadly, we didn't invest in Dart 10-years ago, only investing in early 2018, but we have still made 3x on our investment since then.

Dart provides a useful illustration that company specific developments, in carefully selected long-term investments, will generally be more important in driving value creation than the macro issues getting headlines at any point in time.

Our next best performing investment was Charter Communications, which increased by 18% for the quarter and 70% for the year. Charter goes from strength-to-strength as the market increasingly appears to recognise that the fear over cable TV cord cutting, that dominated investment thinking about Charter in 2018, and which brought the share price down to levels which allowed us to act, were over-done and, importantly, failed to recognise Charter's duopoly like characteristics in providing an essential modern service, that of broadband internet delivery.

Another of our strong performers was ECN Capital which increased in price by 41% during 2019. ECN is one of our special situation investments and was a spin-off from a larger parent in 2016. The senior management team of the parent went with the much smaller ECN capital in the spin-off which is always an interesting sign. ECN Capital also went through a well-telegraphed corporate restructuring (not an operational turnaround) that resulted in a smaller, fast growth and high return on equity company emerging from the other end. During this restructuring process, management bought back over 40% of ECN Capital shares outstanding at what we regard as very attractive prices. During 2019, the picture became clearer to the market and underlying value was better reflected in the share price.

Nexstar also delivered strong results for 2019, increasing in price by 51% for the full year, as the market digested the company's US$7.2 billion acquisition of Tribune Media, which closed in the 3rd quarter of 2019, and made Nexstar the biggest local TV broadcaster in the U.S. Nexstar has delivered tremendous value to shareholders over a long period of time under the current CEO, Perry Sook, by following an astute acquisition and market consolidation strategy. The share price rose, during 2019, as the free cash flow generating power of the combined Nexstar/Tribune entity became apparent to the market. Nexstar has been a wonderful investment for the Fund increasing in value roughly 3x since our initial investment in 2016.

Our worst performing investment for 2019 was Dish TV, an Indian satellite TV company. Dish saw a worsening of competitive dynamics due to the unexpected entry to the industry of a well-funded, and potentially formidable competitor, who recently also entered the Indian mobile phone industry to the detriment of the incumbents in that industry. We chose to exit our position to allocate capital to other ideas.

Our second worst performer for the year was Spirit Airlines which is a U.S. based, ultra low-cost airline. During the year, Spirit was affected by several, severe weather events at its main base in Fort Lauderdale. This was exacerbated by recent actions the company had taken to reduce already low costs, thereby negatively impacting the ability of the company to effectively react to the adverse weather events, and the company guiding to higher than expected unit costs for the year. The fact this occurred under the watch of a new CEO, Ted Christie, only added to the market's unease and magnified the subsequent share price reaction. We believe the company will recover from these events and have maintained our position.

Our third worst performer was BBX Capital which declined in price by 17% over the course of the year. BBX Capital's main asset is a 90% shareholding in Bluegreen Vacations, another publicly listed company, which we also own. We think this corporate structure is confusing and leads to low liquidity in Bluegreen due to the low free float or percent of shares available to invest in by the general investing public. We are engaging with the company to encourage them to streamline this ineffective corporate structure by acquiring the remaining 10% of Bluegreen that they do not own.

We continue to find compelling opportunities in the public market to acquire high quality businesses at prices we deem to be very attractive and which provide the prospect of attractive absolute returns over the medium-to-long term regardless of the fluctuations of the market in the short term.

Our private equity heritage encourages us to view every investment we make as if we are buying the whole company. This helps to keep our focus on the quality of the underlying business, its long-term prospects and the price we are being asked to pay, rather than trying to speculate as to what the market or individual company prices may do over the short-term.

We believe that our fundamental research-driven and concentrated investment approach will continue to generate attractive investment outcomes for our investors, and the team at Avenir remain enthusiastic and focused in our search for the next great investment.

"The most difficult thing is the decision to act, the rest is merely tenacity."

- Amelia Earhart

Best Regards,

Adrian Warner

Managing Director