Firetrail INVESTMENTS

Firetrail Absolute Return Fund

OCTOBER 2018

ABOUT FIRETRAIL

Firetrail is an investment management boutique which is majority owned by the Firetrail investment team. Additionally, the investment team is invested alongside clients in the investment strategies.

ABSOLUTE RETURN FUND

The Absolute Return Fund is a market neutral strategy with minimal correlation to equity market direction. It aims to generate positive returns in all market environments. The strategy is built on fundamental, deep dive research guided by the philosophy that ‘every company has a price’.

INVESTMENT OBJECTIVE

The fund aims to outperform the RBA cash rate over the medium to long term.

FUND PERFORMANCE TO 31 OCTOBER 2018

	Net Fund	Benchmark	Net Excess
1 Month (%)	(1.47)	0.13	(1.59)
3 Months (%)	(3.09)	0.38	(3.47)
Inception (%)	1.32	0.95	0.37

Net Fund returns are in AUD terms. Net Fund returns are calculated based on exit price with distributions reinvested, after ongoing fees and expenses but excluding taxation. Past performance is for illustrative purposes only and is not indicative of future performance.

FUND DETAILS

Unit prices	31 October 2018
Application price	$1.0183
Redemption price	$1.0081
NAV price	$1.0132

Fund Details	
APIR Code	WHT5134AU
Benchmark	RBA Cash Rate
Inception date	14 March 2018
Fund size	$143m
Management fee*	1.50% p.a.
Performance fee*	20% of outperformance

*Please read the Product Disclosure Statement for more details

PORTFOLIO POSITIONING

Top 3 Overweight Holdings (Alphabetical)
Amcor Ltd
Clydesdale Bank
WorleyParsons Ltd

FUND EXPOSURE

	Active weight
Long Equity	151.3%
Short Equity	(151.3%)
Net Equity Exposure	0.0%

PORTFOLIO COMMENTARY

The Fund returned (1.47%) for the one month ending 31 October 2018, underperforming the RBA cash rate by (1.59%).

The performance in October was positively driven by small companies' long positions, and detractors were fundamental shorts and the high conviction long positions.

One of the key contributors to the portfolio during the month was a long position in iron ore producer Fortescue Metals Group. Fortescue produces iron ore that is of a lower grade than most other major producers, and as such its ore attracts a discount. We have been increasingly attracted to Fortescue as this discount has increased, meaning the market's expectations for Fortescue's price realisation have also rebased.

The level of the discount is driven by demand for iron ore from Chinese steel mills. From our research there are two key drivers of iron ore grade discounts:

1. Level of steel mill profitability. When steel mills are highly profitable, they are incentivised to maximise output, which drives the decision to use higher grade iron ore. We have seen this evolve in two ways over the last couple of years in China. Firstly, steel mill rationalisation from supply side reform has significantly increased the profitability from the remaining mills, incentivising higher output. Secondly, pollution led winter curtailments has meant a significant number of mills have a shorter window to produce steel. This has led to a greater reliance on using higher grade ores to reduce downtime and maximise output.

2. Price of coking coal. In addition to iron ore the other key material used in steelmaking is coking coal. There is a balance required in the ratio of coking coal used to iron ore used. When coking coal is expensive, by using higher grade iron ore, mills can slightly reduce the amount of coking coal needed in the blast furnace. This value in use argument has also helped drive the greater reliance on higher grade iron ore.

The discount that Fortescue receives for its 58% grade iron relative to the 62% benchmark iron ore was at its greatest in March – i.e. a 40% discount. Then actual realised price for low grade ore has since bottomed and rallied nearly 40% from its lows, driven in part by a narrowing of the grade discount, but also stronger benchmark prices. Every extra dollar per tonne that Fortescue achieves for its ore is worth $120m on a post-tax full year basis at no incremental cost. This is equivalent to 1.5% of the company's current market cap.

It's great to have a view on the level of the discount but for an investment in Fortescue you also need to have an opinion on the iron ore price itself. In the short term what we are seeing right now is low levels of steel stocks leading into the Northern Hemisphere winter. Due to the level of steel mill shutdowns that occurs each winter as part of China's strategy to reduce pollution, it is important for mills to have reasonable levels of finished steel stocks heading into winter. Hence, we have seen an increase in the iron ore price in the lead up to winter curtailments. Longer term we are seeing China continue to invest in its One Belt, One Road infrastructure program as well as other infrastructure as a key driver of returns.

As at the end of October Fortescue was trading on a 10x Price to Earnings multiple one year forward – a significant discount to the market. Other metrics include a Price to Cash Flow multiple of 4.3x, and a dividend yield of 6%. Not only has the board now initiated a buyback, but now also major shareholder and founder Andrew "Twiggy" Forest recently buying shares on market. We agree with the board and management that the shares are worth buying!

Detractors for the month included a long position in contractor Downer EDI. The market may have been disappointed that there was not a final resolution to its lossmaking Royal Adelaide Hospital services contract. However, this risk has been ringfenced now with a maximum loss of 2% of the market cap of Downer – small when put in perspective. When we look at Downer we see a stock that is trading on 13x Price to Earnings multiple with double digit earnings growth. It also has resilient revenue and earnings streams – with a positive exposure to increased government expenditure on infrastructure and services.

The current fundamental short positions in the fund are dominated by "future earnings risk" positions. This is where we believe there is a significant risk within the next year of earnings expectations for a company having to be lowered.

ONE INTERESTING THING THAT HAPPENED THIS MONTH

The large moves in equity markets during the month. Global equity markets sank during October – the United States S&P500 was down 6.8%, the UK FTSE100 was down 4.9%, and the ASX S&P200 down 6.1%. It was the higher multiple technology stocks that led the markets down – including in Australia where the IT sector was down 11.2%.

As the manager of an absolute return fund the direction of the markets does not affect the returns of the fund. The fund's long positions are equal in size to our short positions which gives us zero market exposure. Our returns are driven by whether we are able to find stock specific opportunities (both long and short) in the market. The fund performance in the month (1.47%) was driven by this.

Interestingly, despite the large moves in markets, it is not what we see when we look at individual company earnings changes. At the start of October, the forward price to earnings ratio of the market was 16.4x, and by the end of month it was 15.4x. Earnings have not moved in aggregate – the equity market has become "cheaper" on that metric. Of the 200 companies in the index there were still 88 companies that had earnings estimates increase during the month. We are still seeing lots of opportunities across the market on the long and short side of the portfolio.

MORE INFORMATION

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