TMS High Conviction Portfolio

Model Portfolio Profile

A Professionally Managed Portfolio of Australian Shares

The TMS Capital High Conviction portfolio is a separately managed account, or SMA, actively managed by TMS Capital Pty Ltd. A Managed Account is a personalised investment portfolio run like a traditional managed fund by professional managers. However, unlike a traditional managed fund or unit trust the investments/shares are beneficially owned by the individual investor(s).

About the Manager

TMS Capital is a boutique investment management business providing unique, direct investment solutions to the private client market.

TMS specialises in the active management of diversified investment portfolios for retail investors, with an emphasis on listed Australian shares and securities.

Model Objective

The objective of the TMS High Conviction portfolio is to provide investors with long-term capital growth and tax effective income. The portfolio aims to deliver a total return performance in excess of the All Ords accumulation index over rolling 5 year periods.

Investment Philosophy

The manager's objective is to generate excess returns over the All Ords Accumulation index. We aim to achieve this by investing in a portfolio of businesses that is truly index unaware, ignores tracking short term performance and has a genuine focus on backing those companies whose profit growth we believe will outstrip the market.

Given a sufficient period of time the market should be efficient at rewarding those businesses of a higher quality than the average.

We seek to invest in those companies we believe have a high probability of significantly increasing earnings per share over a 5 year period. Experience tells us that over such a timeframe total shareholder returns will track profit trajectory.

Our goal is to find those businesses with proven management teams; high returns on capital employed, strong balance sheets operating in industries we feel have structural tailwinds. Our belief is that adopting a buy and hold mentality when investing in stocks offering these attributes will result in superior performance over attempting to trade them.

Key Portfolio Features	
Model Inception	1 July 2016
Benchmark	S&P/ASX All Ords Accumulation Index
Number of stocks	15-25
Cash Allocation	0-50%
Investment Horizon	At least 5 years

Key Portfolio Features	
Authorised Investments	All companies listed on the ASX.

Portfolio Structure

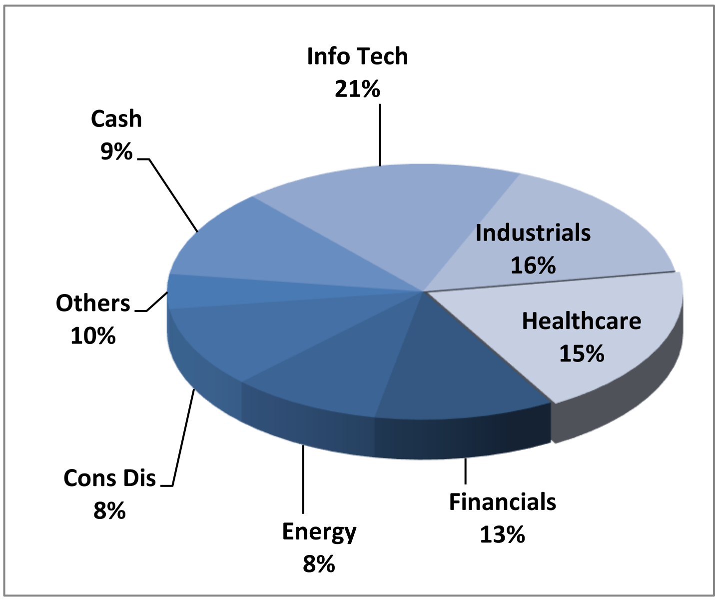
Top 10 Holdings (alphabetical order)

ASX Code	Company Name
ALL	ARISTOCRAT LEISURE
ALU	ALTIUM LIMITED
CSL	CSL LIMITED
FPH	FISHER & PAYKEL HEALTHCARE
MQG	MACQUARIE GROUP LIMITED
REH	REECE LIMITED
RMD	RESMED INCORPORATED
SYD	SYDNEY AIRPORT
TYR	TYRO PAYMENTS
XRO	XERO LIMITED

Performance and Sector Allocation

Return %	3m	1yr	3yr p.a	Since Incep. p.a
TMS High Conviction	**1.6**	**+9.3**	**19.8**	**14.7**
All Ords Accum Index	1.1	-8.8	5.5	7.2
Outperformance	**+0.5**	**+18.1**	**+14.3**	**+7.5**

Past performance is not indicative of future performance.



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Market Commentary

The September quarter was one of consolidation with the market nudging out a 1% return after a phenomenal June quarter. Although the action looked benign there continued to be some incredible share price movements at an individual stock level as investors try and take stock of what the COVID impacts mean for different businesses. What we are seeing happening is a very real change in the index components of the market as some businesses lag whilst others skyrocket. No greater example could be given than Afterpay which is amazingly the 17th largest company on the ASX today – this company didn't exist five years ago. Afterpay is now larger than IAG, Origin Energy and AGL combined, three companies all regarded as blue chips with AGL being the oldest company on the ASX.

Our portfolio finished the quarter outperforming the broader market by 0.5%. It is the years return we are really pleased with however, delivering a strong positive return in such a tumultuous year has been a highlight for the fund.

The market continues to look forward and would appear to be rallying as a result of ultra-low rates, massive fiscal stimulus and surprisingly resilient earnings. In Australia we have seen outperformance from the bourse in recent weeks due to all three of these factors. The government has announced the largest fiscal stimulus program in the country's history which, just as importantly, will be spent in a very short time frame; the bulk of it within two years. The RBA is dual lifting, prepping the bond market for the arrival of quantitative easing, actively considering currency intervention and very likely cutting official rates once again to 0.10%. Finally, the August earnings season was surprisingly strong, in fact (bizarrely) versus analysts estimates it was one of the strongest result seasons we have seen in years.

At a broader level there remains a lot of uncertainty. How long will we live like this? Will we continue to see lockdowns? Will there be a vaccine and if so, how are we going to manufacture 8 billion doses of it? What happens when Job Keeper rolls off? The sentiment still feels quite bearish, no one is banging their chest and Fund Managers are generally still holding a lot of cash. It is for these reasons we feel the market could keep pushing higher although of course no one knows.

The point we would make is now, more than ever, is a time to focus on owning companies who can keep growing regardless of what the answers are to investors questions. All companies are facing issues dealing with COVID but virtually all the companies that are owned in the portfolio managed to grow their profits in the second half of the year… many were at rates lower than we would of expected in February but CEO's have acted very quickly to take cost out and as revenues normalise the profit growth will likely accelerate.

We would warn investors that as news of a potential vaccine appears closer we do feel that there may be the start of a rotation coming with fund managers eyeing off a number of beaten up candidates who have been heavily impacted by the virus which may be funded by selling some of the 'winners' of COVID. This could impact on our performance in the short term as the portfolio has far more exposure to the latter category although several of our holdings will benefit.

In this environment it's important to focus on the principles that have served us well to date and not to get to focussed on the dramatic daily moves we have seen through the year. Some businesses of course will take an earnings hit as a result of the environment they face but it is important to look beyond this time toward where earnings will revert. We will continue to hold businesses we believe:

- Can meaningfully grow earnings over the longer term without the help of an economic tailwind.
- Have invested management teams who oversee a strong company culture.
- Possess attractive financial metrics, ideally reinvesting capital at high incremental rates of return.
- Have the liquidity to survive any more lockdowns.

As the dust has settled and we have been able to better understand the impacts of COVID to various companies earnings we have made a number of changes to our portfolio and bought holdings in several new stocks that we hope will become much bigger businesses over the years.

Portfolio Performance

As we said earlier there was still a lot of volatility in individual companies share prices particularly through the all-important end of year reporting season. Having said that investors demonstrated an ability to look through short term COVID issues and focus on the longer-term outlook for businesses.

The best three performers in the portfolio were:

- Reece (+41%) which took off on the back of its August result showing much stronger than expected US sales growth from the Morsco acquisition made three years ago. Peter Wilson (CEO and owner) has spoken for several years around listening and learning about the US market before implementing changes and those changes are starting to flow through the business. This was one of the best results we listened to.

- Wisetech (+33%) which was the other highlight of results season reporting a much stronger than expected set of numbers. This is a really interesting company to track as they are providing logistics data in real time to their clients. In hindsight, when they shocked the market in February with a downgrade citing a highly irregular environment in China it was the canary in the coalmine for what was to come. However on an optimistic note CEO Richard White was very bullish on the call, saying logistics activity had since accelerated beyond pre-COVID levels and the complications the virus had created with border closures etc. had seen one of the best periods of new customer wins in the company's history.

- Afterpay (+31%) who continued their recovery on the back of a surge in online shopping combined with a phenomenal level of take-up on the platform in the US. In just 2 years the company has seen 5 million Americans become active customers and is now rolling out into Europe. Post end of quarter the company's share price has hit $100 for the first time, returning the fund 14x its money in three years based on our initial purchase price ($6.82).

The worst three performers were:

- A2 Milk (-24%) which despite reporting a very strong result in August – earnings per share growth of 33% for FY20 – was forced to downgrade its guidance at the end of September due to a drop in purchasing activity by daigous in Australia due to reduced tourism from China and international students. Although this came as somewhat of a surprise (the company reaffirmed guidance just three weeks earlier) the company is still guiding for 7% revenue growth which is very healthy in this environment.

- Paradigm Biotech (-15%) which took a breather on little news post a very strong prior quarter.

- Resmed (-13%) that has seen a slowdown in its core sleep business in the US as doctors focus on more important issues and hospitals were closed off to sleep testing. Somewhat offsetting the weakness was the phenomenal result from the respirator division, Resmed sold 5x more ventilators in the past 6 months than it did in the 6 months prior.

As of September 30 the funds cash position was close to 7%. The ability of a manager to rapidly skim and add to positions through short term volatility is a key advantage we believe the SMA possesses. We were more active in this respect through the quarter than normal taking advantage of the volatility.

Portfolio Commentary

Through the September quarter virtually every company on the ASX reported their end of year financial result. Given virtually all company's withdrew guidance through the half it was fascinating listening to the various CEO's talk about the implications for COVID on their business, how they were dealing with it and how they felt the industry structure was changing.

A great example was Aristocrat (who held their AGM). This business is rapidly morphing into an online gaming company which we were optimistic about but there's no doubt the high margin, land based gaming business had been heavily impacted as casino's across the United States were forced to close. CEO Trevor Croker started by telling analysts the company was looking to take cost out of the business where it could but was adamant it would not cut back on its R&D spend and was actually using the downturn to lure the best software engineers it could find. Meanwhile the two key competitors; Scientific and IGT had immediately frozen spending.

When the company presented casinos were starting to reopen in the US and the most interesting person to listen to was their head of land-based sales in the US, Mitchell Bowen. Mitch described a scene of semi chaos across the market. Casinos across every county in every town in every state through America were opening at different rates with completely different rules. Cleaning practices, separation of machines, screens between machines, operating hours, % of floor space allowed, patronage numbers, food and beverage service, use of cash – the list goes on. Gaming floor managers were overwhelmed and under a lot of pressure to get moving and trading.

Aristocrats response was to immediately deploy their entire sales team into the field. To sit with managers and ask how they could help, where were the pain points, what could be done to solve them. They then organised a team of cleaners, carpenters, electricians, and removalists to get in and help solve the client's problems. Mitch was quick to say the obvious, this was not a completely altruistic effort, the end goal was to keep as many of their machines on the floor vs their competitors as they could. But he also said the effort to support key decision makers was massively appreciated and has cemented strong relationships.

Aristocrat warned of short-term challenges at their AGM. These efforts cost a significant amount of money at a time when dramatically reduced revenue was coming in the door. Difficult conversations were to be had with clients who were fighting for their survival to rework existing contracts. But with short term pain we feel will come a stronger, more dominant business that will grow at faster rates if not for COVID.

We heard many of these stories through reporting season. Everyone had issues but some companies were seizing on opportunities, investing whilst others were forced to batten the hatches, pivoting the business to growth. It is the culture of a business that comes through at times like these.
Being able to rapidly adapt, having a workforce that is willing to buy in and help solve problems whilst being able to listen and respond to ideas from across the company. Culture is not easily measured and can only really be assessed by getting out and listening to the company's leaders. We strongly believe that many of our businesses will come out of this black swan event in even better shape because of the way they ran the company before COVID hit.

Portfolio Changes

Only one stock was sold out of during the quarter – Mineral Resources. This company has very high operating leverage to the iron ore price and after a phenomenal run in iron ore (and an even stronger one in the share price) we made the decision to take profit and hope to re – enter at a less euphoric time.

We saw a number of interesting presentations from businesses through the quarter as the capital raising wave continued. We entered into a new company called Eroad through an institutional placement as the company which is listed in NZ dual listed onto the ASX. This is a fast growing SAAS business that offers products to help fleet management and transport companies save time and money on their vehicles whilst reducing risk.

We also bought into a company called Audinate which we have long had our eye on. AD8 are transforming the way the global AV industry operates through its Dante technology solutions, removing copper wire and replacing it with cheaper and more user-friendly networking solutions.

A third company we entered was Iress Market Technologies. We know this business well, not only would Iress be one of the Exchanges earliest tech companies but it is also a business whose products we use on a day to day basis. The Iress and XPlan platforms are heavily entrenched in the financial services industry and a client would be taking on a lot of risk to their business if they decided to move elsewhere. The share price has weakened off over the year, largely over concerns around the number of advisors exiting the industry (less advisors means less licenses) however we feel this could be offset by the sale of new offerings, particularly in compliance, and gradual price rises.

Finally, we bought into a company called Zoono, another Kiwi business, which has experienced a meteoric rise in the demand for their TGA approved, pathogen killing cleaning solutions. Although the company is experiencing what can best be described as 'growing pains' as it rolls out its products globally if it can execute well, we believe it has huge potential.

Three of these companies are small in size and not all will realise their potential. We have hence taken small positions and will be watching closely to assess whether we should be adding to them if they are showing signs of succeeding.

Over the quarter we added to our holdings in A2 Milk, Appen and Sydney Airport. We reduced our holding in Afterpay.

Looking Forward

We are experiencing an unprecedented time and it is not clear where markets will head from here. Valuations appear expensive on a near term basis albeit against earnings that contain a hefty one-off hit. Interest rates have fallen significantly, and equities look highly attractive versus other asset classes taking a longer-term view. We expect the rate dilemma to support the market over the short term.

In a period of economic decline, it is more important than ever to find those stocks that can grow their profits without relying on a growing economy and looking to our portfolio we are confident in its future. Our collection of companies will grow their earnings significantly faster than the overall market in FY 2021 and beyond. They have some of the most impressive CEO's in the country at the helm looking to leverage opportunities with much stronger balance sheets than the overall market.

This is more important than ever. Sticking with these businesses is the key to long term investing success.

$500,000 invested in the fund at inception – 1 July 2016 was worth $877,014 as at Sept 30, 2020.