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

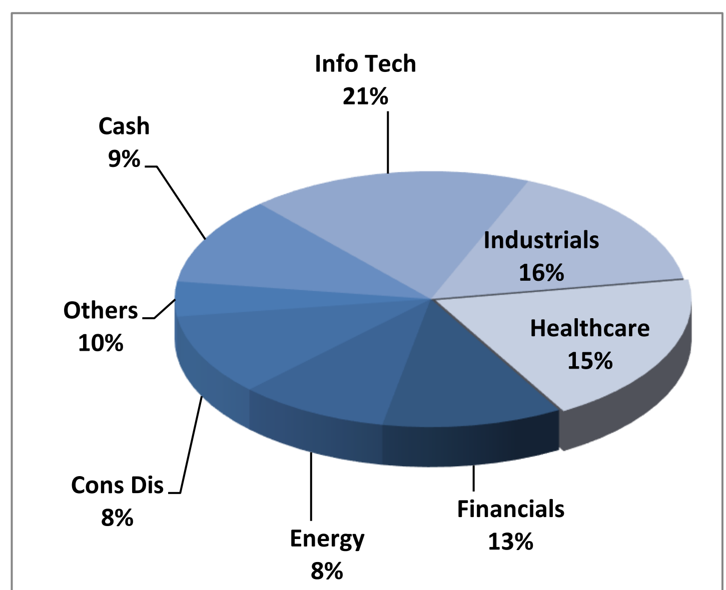
Top 10 Holdings (alphabetical order)

ASX Code	Company Name
ALL	ARISTOCRAT LEISURE
ALU	ALTIUM LIMITED
APT	AFTERPAY TOUCH
CSL	CSL LIMITED
FPH	FISHER & PAYKEL HEALTHCARE
MQG	MACQUARIE GROUP LIMITED
RMD	RESMED INCORPORATED
TYR	TYRO PAYMENTS
WTC	WISETECH GLOBAL LTD
XRO	XERO LIMITED

Performance and Sector Allocation

Return %	3m	1yr	3yr p.a	Since Incep. p.a
TMS High Conviction	**-6.9**	**33.7**	**15.9**	**14.0**
All Ords Accum Index	3.6	41.1	10.1	10.3
Outperformance	**-10.5**	**-7.4**	**+5.8**	**+3.7**

Past performance is not indicative of future performance.



Market Commentary

The March quarter started to see some calm pervade the markets as volatility dropped away and we cycled the one-year anniversary of the global pandemic. The quarter saw what analysts loosely refer to as rotation from "growth to value". This means there was selling in high-PE stocks in favour of those on lower PEs. In other words, winners over the last few years suddenly became the losers, and the unloved became loved. Markets do this from time-to-time, and it is fair to say the move back to value was overdue against historical performance. The catalyst was a readjustment in bond markets; at Christmas the 10-year Government bond was at 0.8% but it had moved to 1.8% by mid-February. This hurts high PE stocks by reducing the value of future earnings; in turn, today's earners are more appreciated. As we write, the bond market has stabilised, but the rotation has continued, reminding of the powerful readjustment markets can have when at last they decide they are ready to shift gears. The movement in bond markets was violent but is calming, the 10-year bond yield is shown below:

In the last three reports we have warned that we felt this rotation was coming. The Australian economy is booming, and this year may be one of the strongest years of GDP growth we have seen in decades. As we write this report the US has just printed 6.4% GDP growth for the March quarter, a period when most of the country was in lockdown and vaccines were only just starting to be administered…. it is not inconceivable that as the country reopens and Bidens massive stimulus programs take hold that GDP growth could hit double digits. We are truly witnessing an historic period.

An obvious question investors may ask is if we saw this rotation approaching why didn't we adjust the portfolio to take advantage of it? And it is a fair one. Our approach when buying a company is to truly try and think ten years ahead. We believe the biggest edge an investor can have against the market is time. As algorithmic trading has exponentially increased the market has increasingly become shorter and shorter term focussed. Share prices reflect a company's prospects for 6 -12 months at best and although it is a good way to signpost where the businesses trajectory is headed it also reflects emotions; greed and fear. We try and think of ourselves as a business owner, not an investor and believe that what Buffett refers to as the 8th wonder of the world – compounding returns, is only captured by those who truly think and invest for the very long term. It makes complete sense that over a year or two-time frame lower quality, cheaper businesses that have caught an unexpected economic tailwind have re-rated. But from our point of view, it is illogical to sell the businesses that will dominate their respective industries in the future to buy into companies that dominated the past.

Earnings season also hit with full force and again saw some of the highest percentages of 'beats' we've seen in recent memory. Across the ASX300 28% of companies beat consensus whilst only 19% missed. Across the market we saw one of the largest upgrades to consensus earnings forecasts since 2007. Ultimately earnings drive share prices and the upgrades to earnings expectations that we saw coming out of February was the tonic the market needed to continue its strength.

The story, as always within the market was polarised, however. Covid has created headwinds for some, tailwinds for others. We believe that as spending habits start to normalise through 2021 and economies reopen the market will become more focussed on what the profit glide path will look like going forward for different companies from potentially elevated levels or depressed levels. What we can say is profit normalisation for every company will happen at different speeds over different time frames.

Take two of our companies as an example. Appen is the global leader in providing critical data needed by companies who are creating and utilising artificial intelligence (AI) within their business. It is estimated that for every dollar spent on AI, 10% of the spend is on the data the machines need to get faster and ever more accurate. Between 2019 and 2024 it is projected that global spend on AI will rise from US$37.5bn to US$110bn.

Appen downgraded guidance in February primarily due to three impacts. Firstly, their key customers (Facebook, Google, Microsoft) saw unmet needs and opportunities created by Covid and rapidly pulled forward some significant new projects whilst pulling resources off more mature parts of their businesses. This led to a drop off in the demand for the data they had previously signalled to Appen they'd require. CEO Brayan commented its inevitable this demand will return but it's very hard to get a read through of when. Secondly, with California and Seattle in hard core lockdowns Appen was struggling to communicate and work with the teams of engineers across these companies as they typically would – Brayan remarked "despite what you read in the papers running a high growth global business over Zoom is not

ideal'. Finally, Apples move in its latest IOS update to require consumers to 'opt in' to receive targeted advertising through the Facebook platform has likely led to a drop off in demand from a key customer as they wait to see how this plays out.

To us, Appen looks like an FY22 earnings recovery story given many of these issues are impacting the company well into the second half of the calendar year, but again taking a longer term view the company could generate very strong share price performance as it cycles through these impacts.

A brighter spot in the portfolio has been Aristocrat Leisure which at time of writing has reset an all-time high. Post end of quarter we attended a Zoom round table with management from Las Vegas to get an update on the business. Aristocrat is a business that was at the very pointy end of COVID, as lockdowns across the US were slowly rolled out casinos were forced to close. For those States that did not enforce lockdowns social distancing and reduced visitor numbers within casinos was required creating a significant, almost instantaneous drop off in demand. We have discussed the challenges the company faced in detail in our June 2020 report.

Fast forward to today and what a difference a year makes. CEO Croker advised that demand is roaring back as vaccines are delivered and Americans can get back to doing what they enjoy. Of the 8 largest resorts in Vegas there is a less than 1% vacancy rate on weekends for the next 12 months. We read an article on the WSJ quoting the head concierge at Wynn Resort who said trying to secure a pool cabana now was harder than on a normal NYE. The earnings 'glide path' for Aristocrat looks like a V with the recovery set to overshoot where the company would otherwise be if not for Covid. The digital gaming arm has probably been pulled two to three years forward by locked up consumers. The two major competitors have been hit very hard, froze all R&D spend and aggressively laid off staff. Aristocrat spent every dollar they had earmarked for R&D despite the crises, their very conservative balance sheet gave them the ability to tighten the noose on the competition. Croker's final comment – 'the next decade for Aristocrat will be significantly stronger than the last' appears prescient.

We will reiterate in this environment it is 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.

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:

- Betmakers Tech (+55%) which we bought into during the quarter and has come hard out of the blocks. We discuss the company in some more detail at the end of this report.
- Reece (+16%) that reported a strong set of numbers, particularly out of the ANZ business which running into COVID had concerns around a slowdown in new housing construction and renovation activity. Of course, as a result of trapped money in the country and all of us spending more time working from home there has been a rapid improvement in the outlook for local demand. It is the US acquisition that we think the market has really cottoned onto, however. After three years of CEO Wilson saying they were watching and learning the US market after taking control of Morsco the company is starting to role out changes to the business which are flowing through to the top and bottom line of the business. Again, COVID appears to be blowing an accelerating tailwind across the US operations. The country is likely (we believe) six months behind the spending themes we've seen in Australia however we believe the strength of the recovery could be far more dramatic. COVID has seen an acceleration in the trend of Americans emigrating from North to South, chasing warmer weather and more space. This is in turn speeding up building activity at a time when the housing market is starting to run. Morsco is the largest plumbing player across the South, particularly in Texas.
- Aristocrat (+11%) which we've discussed in more detail previously.

The worst three performers were:

- Zoono (-54%) which was heavily sold off as the UK and Europe reimposed severe lockdowns leading to the closure of many of the sites that the cleaning product is used in. The promised US approvals also did not eventuate with shareholders seemingly losing complete faith in management. This is a small holding in the fund and looks

interesting but the market is clearly taking a view that as vaccinations are rolled out the demand for their products will fall away. Post end of quarter the company announced it had received US approvals that the product does eradicate COVID for the 30 day marketed period and that both Microsoft and Boeing had signed on as customers of the company.

- Appen (-35%) that was discussed in more detail previously.

- A2 Milk (-31%) which continued to fall as the market kept pushing out the projected timeframe that the Chinese will be able to return to the country and resume their normal spending behaviour. Although this situation remains highly uncertain the market will start to price this recovery in well before the fact. A2 is a highly attractive business which even through its COVID induced slowdown is still generating EBIT margins close to 30%. In terms of its glide path to earnings recovery we feel it will be further out than most growth stocks and we do not discount further bad news before the sales trajectory turns.

As of March 31 the funds cash position was close to 1.6%. We are increasingly bullish on the medium-term outlook for the market but more particularly for a number of our holdings from their current price levels.

Portfolio Changes

One stock was sold out of during the quarter – Eroad, which fell into the 10% basket we can apply in trading situations that may not necessarily meet our quality criteria. We were offered shares in the company through an institutional placement at $3.55 in Sept and after a very strong run in the price despite a fairly lacklustre Dec quarterly we decided to exit the holding over $5 per share in January.

Over the quarter we added to our holdings in Altium, CSL, Fisher & Paykel Healthcare, Tyro Payments and Wisetech.

We skimmed our holdings in Afterpay, Macquarie Bank and REA.

Stock in Focus: Betmakers Technology Group

Betmakers is a company we had been watching closely for the last twelve months after ruing missing out on investing in Pointsbet at an earlier point. One theme we believe will be a thematic over the next decade is the legalisation and opening up the US sports wagering market.

We listened in to a global gaming virtual conference hosted by Goldman Sachs in the US in March where a number of companies and key opinion leaders discussed how this market is likely to evolve. Sports betting and iGaming is being legalised on a state by state basis with 95% of states expected to legalise within the next decade. Florida, NY and California are widely expected to legalise in the next 12 – 24 months. This is creating a land grab as key media, private equity, offshore and local companies jostle for position. The reward is enormous. Goldmans expect the current global sports betting market (estimated at US$39bn) to increase five-fold through to 2035 as the US comes online and the US market specifically to grow at revenue rates of 40%+ CAGR (Compound Avge Growth Rate) for the next decade. They envisage long term EBIT margins of 20-30%.

Betmakers provides services to racing bodies and bookmakers in the horse racing industry to enhance the quality of their products and services. Examples are such things as providing the optimal odds, speeding up customer acquisition and adding betting features into their online platforms. The company provides a white label product in Australia which aggregates bookmakers and provides customers with a look through at the best odds across the industry. Think of it as the Expedia of horse betting.

In Feb 2020 BET signed a landmark 10-year deal with the New Jersey Thoroughbred Assoc. to deliver and manage all fixed odds racing content in New Jersey that is fed into New Jersey bookmakers and then from bookmakers outside of NJ, including internationally. This has the potential to open the floodgates for BET to become a real player in the US market.

Following on from this in February 2021 BET announced that Matthew Tripp had signed on as a special advisor to the company and had agreed to personally purchase $25m of BET shares at $70c per share. Matt is widely regarded as the canniest player in the Australian sports betting market having started Sportsbet before selling out to Irish giant Flutter and then turning around CrownBet on behalf of James Packer before successfully selling the business. With this announcement we felt the stars had aligned and bought into the company, we have the highest quality player in the industry moving into the business and taking a significant personal holding. The industry itself is about to catch a massive tailwind of growth and the potential on offer is a highly capital light business earning significant margins and a very strong balance sheet.

We would caution it is still very early days and we believe that Flutter, Penn Sports, Entain and BarStools are likely to be the dominant players fighting for their piece of the pie. There's no guarantee that BET will become a meaningful player but they appear to have a fighting chance.

Looking Forward

We are experiencing an unprecedented time but there does appear to be growing confidence amongst investors we are through the worst of the COVID impacts to the market. Valuations appear expensive on a near term basis albeit against earnings that still contain a hefty one-off hit. As companies are cycling through their trough in earnings we expect the upcoming February reporting season could well exceed analyst forecasts following on from a much better than expected February season.

Interest rates have fallen significantly, and equities look highly attractive versus other asset classes taking a longer-term view. We expect a combination of the rate dilemma and stronger than trend earnings growth to support the market over the short term.

As the local economy snaps back in 2021 the more cyclical / value businesses could continue to outperform the broader market in the short term. Any re-rating we believe will be fairly short lived and transitory in nature.

We believe it's more important than ever to stick to our investment philosophy of concentrating on companies that can materially grow their earnings for many years to come regardless of the ebbs and flow of the economic environment. We are seeing more attractive opportunities in this collection of companies than we have seen for some time. 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 $910,014 as at March 31, 2021.