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 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 return 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

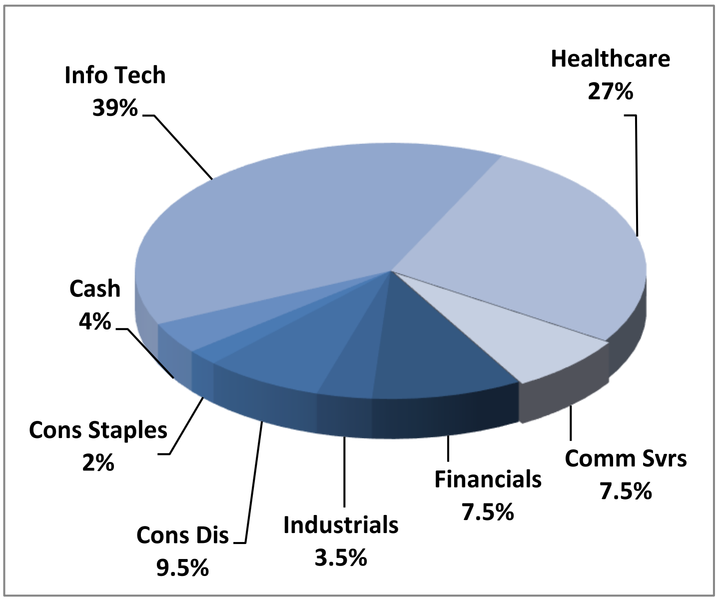
Top 10 Holdings (alphabetical order)

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

Performance and Sector Allocation

Return %	3m	1yr	3yr p.a	Since Incep. p.a
TMS High Conviction	**7.1**	**23.5**	**14.0**	**16.3**
All Ords Accum Index	2.0	31.5	10.4	11.4
Outperformance	**+5.1**	**-7.9**	**+3.6**	**+4.9**

Past performance is not indicative of future performance.



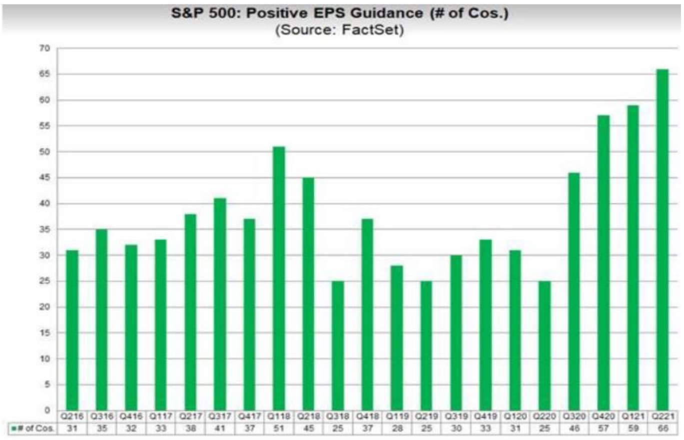
Market Commentary

The September quarter was surprisingly calm for what was a highly eventful few months. We of course had the full year results season which from a top line point of view was decent and largely in line with long term averages. Of the ASX300 89 companies beat expectations and 52 missed with the remainder in line. The results were, however, overshadowed by NSW and Victoria moving back into lockdowns and the near-term uncertainty it's created for business. The vast majority of companies again reverted to providing no guidance for the coming year, understandable given the unpredictable knock on impacts we've all seen as a result. The upcoming AGM season will have more attention than normal as we are likely to see how companies are trading in the current year.

Three key issues many companies identified are labour shortages, supply chains having been crunched and shipping costs having risen close to 500% since COVID. This is having a flow on effect for many companies who aren't directly exposed to it.

Of our companies we were broadly very happy with how they reported, we only had a couple that disappointed which we have made some comments around below. Although every business is dealing with issues at present which will likely last several years it's been really pleasing to see so many of our stocks take advantage of the new environment they find themselves in. A lot of this comes down to culture and people, something you can only put your finger on by meeting with management and getting in front of them as often as possible.

The US second quarterly earnings season also played out and saw the opposite theme occur with the highest number of companies in five years guiding for positive growth. Another way you could look at it however is that of the S&P500 435 companies expect flat to negative growth!



Source Factset

This of course comes back to the fact that the big index weighted companies in the US are growing rapidly and are highly likely to continue to do so... the challenge in America is not finding blue chip companies that are growing healthily, its working out what one should pay for them.

Here we continue to see an opposing theme where our largest companies are generally struggling to eke out any form of sustainable long-term earnings growth, it tends to occur in fits and spurts (banks and resources) and is largely outside of the companies' control. In some ways we have the opposite challenge to US investors; what are you happy to pay for a business with these characteristics? An interesting table we came across that plays to this theme is below. The Australian share market has been much less dynamic than the US and when you consider what proportion of our market the below companies still make up, we believe the returns over the next decade are likely to be more muted if you just own the index. Our fund only owns CSL in the below list.

Top 5 Companies

Australia		United States	
35 years ago	Today	35 years ago	Today
Westpac	Westpac	IBM	Apple
CBA	CBA	Mobil	Microsoft
NAB	NAB	Exxon	Amazon
ANZ	CSL	Ford	Alphabet
BHP	BHP	General Motors	Facebook

Source: Business Council of Australia, Living on borrowed time report.

In our first quarterly report for the year we discussed the concerns around inflation which had caused long term bond yields to spike as the market priced in central banks being forced to lift rates to combat it. This trend had seen growth stocks be sold off and economically sensitive businesses re-rate. The money had reverse coursed over the past six months with real long term bond yields (yield – inflation) going negative for the first time. However, in the last few months we have seen the trade re-emerge. This is being fueled by three factors: an unexpected boom in energy prices (coal, gas and oil) adding to pricing pressures. The looming reopening of the Australian economy which will likely see another boom in consumer spending and the announcement from Merck of a breakthrough Covid treatment drug; Molnupiravir.

The bond market had been looking through COVID created price spikes (shipping costs, used car prices, chip shortages, renovation booms) and appears to be refocusing on inflationary forces. Although no one knows the future the vast majority of global managers still appear to be taking the view this is a transitory phase albeit some are moving to a view inflation could become more structural in nature.

Bond investors in Australia are currently pricing the average interest rate for the next 10 years at 1.85% (shown below). Although there will likely be some wobbles when central banks start to taper their quant easing programs and then when rates do start to move higher taking a longer-term perspective it should be a great time to be an investor. Our view is that there will be a normalistion of rates over time, which is a healthy thing. However, it's highly unlikely rates will move to anywhere near the levels we've grown accustomed to. Although its bad news for returns on the cash and fixed interest components of client's accounts its highly supportive for share markets.

The key is finding those businesses that can grow in a heavily growth constrained environment – and sticking with them.

We remain of the opinion we are traversing a booming economy in 2020/21 to a normalisation to a lower growth world in coming years. There will however continue to be selective areas of unusual growth from knock-on COVID impacts. Given the Australian market still has a heavy index weighting of economically sensitive businesses we believe forward returns of the local index will be more muted over the next three to five years.

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 balance sheets that allow the company to not only survive the unexpected but take advantage of opportunities that arise through it.

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:

- WiseTech Global (+69%) which jumped on the back of a much stronger than expected full year result combined with the news that post end of year the company had signed up FedEx to the Cargo Wise platform. We view this news as a game changer for the company, creating significant validation of the platform whilst pulling many smaller clients onto Cargo Wise who provide infill and last mile services to FedEx.

- Resmed (+47%) who also delivered another typically strong quarter of revenue growth (+14%) but more importantly for the first time discussed the implications of the global product recall of Phillips CPAP machine. CEO Mick Farrell suggested that Resmed could increase sales over the next twelve months by US$300-350m as a result of patients and doctors being forced to move to their newly released machine. The biggest issue the company is facing in maximizing their advantage is dealing with the stress that their supply chain is under and trying to fulfill as many orders as possible. Farrell stated that the company had already been forced to an allocation policy and that every effort was being made to keep up with rampant demand. The stakes are meaningful for the company and potentially could see a semi-permanent increase in market share. Once patients go into ResMed's ecosystem, it's fairly hard to leave.

- Afterpay (+43%) who announced that they had accepted a US$29 billion offer to acquire the company by US payment giant Square. This appears to be an exceptionally timed deal that offers significant strategic benefits to both parties. Afterpay was first purchased in the fund in Feb 2018 at $6.86 and has been held since (albeit frequently right sized to control some risk). It would have to have been one of the most divisive stocks on the ASX but ultimately it's been a once in a lifetime investment rising over 2000% during our ownership. We continue to view this news as another step in the journey and are planning on continuing to hold Square as an ADR on the ASX.

The worst three performers were:

- Appen (-18%) which was heavily sold off post result as the company posted an 18% reduction in underlying operating earnings largely driven by a slowdown in spend by their major customers (Facebook, Google etc). Appen has always been a company that has generated sales through contracted services which can be hard to predict, lumpy and easily delayed (or pulled forward). It would appear that the recent issues facing the business have flowed from increased regulatory oversight of big tech and changes that Apple are allowing consumers to make when using these platforms. Although the company stuck by its full year guidance it is now heavily weighted to the second half making them a member of the so called second half club.

  It has been a painful period for shareholders, but we are increasingly hopeful that the company will emerge from this downturn in much stronger shape. The CEO was heavily quizzed on the call over shorter-term guidance and made a strong case for why he believes guidance can still be met this year. It is the longer-term outlook we are more focused on, however, and its apparent that Appen will emerge from this with a better diversified client base with a revenue base that is more predictable and repeatable.

- Link Market Services (-10%) which printed a disappointing earnings result, flagging that profit for the 22 Financial Year would grow but be lower than market expectations. This is principally due to the relatively new CEO deciding to reinvest higher projected revenue more aggressively into the business. Although we've often seen kneejerk selloffs on such announcements from a short-term focused pool of investors we would agree in this case we are a little more wary about whether this is simply a resetting of the cost base to churn our similar levels of projected revenue growth. PEXA remains the crown jewel in the Link business and the reason we bought into the stock originally, but we do now have the option of investing purely into the company since its IPO. Link are holding an investor day in November where we hope to get more clarity around the outlook for the remainder of the business.

- Paradigm Biotech (-10%) which continued to fall as the projected timeframe that the company hoped to commence its landmark Phase 3 trial was pushed out by further FDA requests around the trial design and as COVID continued to create a backlog of work for the agency. We are hopeful that we may see the Investigational New Drug application (IND) be unlocked this quarter, commencing what has the potential to a landmark trial of the world's first osteo arthritis treatment.

As at September 30 the funds cash position was 1.6%.

Portfolio Changes

Over the quarter only one change was made to the portfolio which was a small allocation we gained access to in the IPO of Touch Ventures. Touch was founded in 2019 with Afterpay as its largest shareholder, owning 24%. The company is somewhat akin to a venture capital fund with a goal of owning up to 10 material investments in unlisted companies.

Touch came to the market with holdings in five companies, four of which have been originated by Afterpay. The logic to us in this venture is compelling. Afterpay have a proven management team who within a decade have driven an effective start-up to one of the biggest transactions in Australian corporate history. They have fantastic relationships with merchants all over the globe and will be able to see where there are 'pain points' for retail or consumers that can be solved through innovative new technologies. Having an equity interest to drive the take-up of these solutions could hyper scale growth for the start-ups they partner with.

On the flipside, for a company needing to raise funds one can only imagine that having Afterpay, and the associated management expertise and relationships is a huge strategic selling point to a founder in what is a crowded VC market where everyone is looking for the best opportunities. It would overnight bring the company onto the radar of others and likely see a much higher multiple applied in subsequent funding rounds… not to mention the acceleration in sales growth that will likely occur.

This venture makes a lot of sense to us although we would caution will be volatile and take some time for funds raised to be allocated.

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 interest rates that will remain compressed for some time. We are firming in our view that earnings across the market may have peaked in the short term when looking at the larger index components. Although sales growth still appears to be growing above trend we are starting to see a similar pattern in cost growth which is impacting market earnings.

We expect interest rates to start being lifted next year, and although this could cause bouts of volatility equities look highly attractive versus other asset classes taking a longer-term view.
As the local economy continues its snap back into 2022 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. 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 $1,081,326 as of September 30, 2021.