Transcript

The Ideas Exchange
Episode 10: Foraging for investment opportunities with Forager Funds Management

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Voiceover Welcome to the Monthly Ideas Exchange podcast brought to you by ASX, the heart of Australia's financial markets. Each month we'll connect you to a range of leading industry experts who'll give you a look into the finance industry and deliver valuable insights, hear about important market events, industry research, tips for your own market research, as well as innovative products to help you diversify your investment portfolio.

Martin Dinh Hi, everyone. Welcome to the Ideas Exchange podcast. In today's episode, I speak with Steve Johnson from Forager as we learn a bit about the Forager journey, including what type of companies he looks for, how his investment philosophy has changed over time, some of the ups and downs, his views on inflation and a whole lot more. So an exciting episode ahead. Let's get into it with Steve. Hi, Steve. It's great to have you here today.

Steve Johnson Hi, Martin. It's good to be on.

Martin Dinh So Steve, before we actually get into it, I just want to let you know that I've actually been following your story and your journey over the last few months after a friend of mine, Ian Irvine, who you might be familiar with, suggested that I bring the Forager team onto the podcast. And I have to say your journey has been one that's been really fascinating. I think the reason why is that there has been so many ups and downs over the last few years, which I'm sure we're going to cover. So I'm kind of really excited to speak to you and hear about some of those investment stories and learn about really what goes on in your mind when you are deciding which stocks to include in your portfolio. So I think a nice way or the best place to start Steve, is maybe if you could provide a bit of background of who Forager is and maybe also go through Forage's investment philosophy when it comes to deciding which stocks to invest in.

Steve Johnson Sure. And maybe a little bit of history is a good way, I guess, of bringing that topic to the fore. We actually started or I started the funds management business here underneath the umbrella of Intelligent Investor, which is a subscription research publication that a lot of people out there might be familiar with. And the business was actually called Intelligent Investor Funds when we first kicked things off, and in 2014 we sold the newsletter business to InvestSmart and we wanted to focus on funds management. And we had to come up with a new name for the business because we were selling Intelligent Investor and we weren't able to call the business that anymore, which I was really excited about because I was never completely comfortable with that name, it being borrowed from a very famous Ben Graham book, and we had to decide what we're going to call the business. And that was a lot of, I guess, soul searching from us around what the business was about, who we were and what we wanted to be. And the name Forager, I think explains a lot about what we are trying to do as an investment firm. We're out there looking for things that are undiscovered or not noticed by other investors and aiming to earn higher than market returns. When we find those sorts of things and you know, some people hear Forager and they think about someone walking around the tip looking for junk, the original idea when we thought of it was, you know, someone foraging around for truffles out in the forest. And in fact, truffle was one of the words that came up when we were talking about what we're doing. You know, they're ugly and they smell, but they're worth a lot of money and that sort of explains some of the things that we're looking for. Really, we do a bit of both of those sorts of things, but we're happy to find things that are just really cheap that we're trying to recycle at a higher value. So, you know someone's rubbish at the tip that you can take them to the recycling centre and get more money for it. Or we're trying to find high value businesses that we think can grow for a long time. But there's still some reason why people have not recognised that growth or the quality of that company. So, we call it variant perception but we're really out there looking for opportunities where we think we know something about that business that lets us value it at higher than the market is currently valuing it at that point in time. And really, that's the crux. There's a lot of, I guess, detail that we'll get into today, and there's been a lot to learn from me in terms of taking that philosophy and running funds that have got hundreds of millions of dollars in them with. But that's the crux of what we do, and it's been the case since we started and it will be the case forever.

Martin Dinh A quick question on the back of that one. How many stocks do you think you and your analysts look at in a week and how many actually get through?

Steve Johnson Well, I think it varies depending on which fund you're talking about. I'd say with the Australian fund, there's probably 400 ASX listed stocks that are in our universe of actually being investable. There's two and a half thousand stocks on the stock exchange. Thousands of them are too small for us to even consider. Others are just too big and too widely covered. And then there's stocks that are in industries that we find are very, very difficult to value, so rule those out as well, and you're down to about 400 stocks. And really, with a team of two and a half, me and two full time people, we should be able to be at least aware of and on top of all of those 400 stocks that are on the ASX. So we're not often looking at something that is brand new, but we're trying to across the course of the year, take a pretty decent look at all 400 of those companies and meet management teams and go to presentations and things. So, you know, some of those are four and five times a year, some are once a year, but that's more of the process than us trying to turn a lot of new rocks every week. On our international funds, which is quite different and I guess more similar to the early days of our Australian fund, where we only had 10 or 15 million dollars in that universe was much bigger. We tend to be a lot more selective around where we spend our time, and that is around where we think the market might be getting things wrong at any particular point in time. So instead of saying we're going to try and cover the whole world, we say, well where might people be making mistakes in terms of how they value things? And let's go make sure we're spending our time in that particular area. And the number of stocks can vary quite a bit. But you know, I would expect an analyst to be looking at at least 10 companies that they haven't previously looked at a week, to be working pretty hard on two or three at any one point in time and then to be presenting at least, at least one idea to the team a month. And then maybe one in two of those actually get through to the portfolio. But the thing can change a lot is the weighting of those opportunities. You know, someone might come and pitch an idea and say, I love it, and I think it could be five per cent of the portfolio, and by the time we've gone through the process and asked a lot of questions, we might as a team collectively decide, okay, let's do a percent or a percent in a half here until we have more certainty around some of these things that we're not sure about.

Martin Dinh So Steve, you launched the Forager Australian Shares Fund, that's an ASX listed investment trust, which investors can buy and sell through their broker. And you mentioned before, you launched it, was it back in 2009?

Steve Johnson Yeah. So it was an unlisted fund back in 2009, and we ran it as a... The lingo is open ended, but it was a fund that you could enter and exit at net asset value, it was monthly pricing back in the early days. But for the first seven years we ran that as an open ended fund that was growing over time because people were putting more and more money into it. And then in 2016, we decided we didn't want to raise any more money. It was at a size that we thought was big enough. Also we were, and we still do, have fairly large investments in some small and illiquid investments, and we thought it was an opportune time to turn that open ended trust into an ASX listed closed ended vehicle. So it's now trading on the ASX and something which I'm sure we'll come to you later, it's actually trading at a fairly big discount to its net asset value at the moment, which is something that we contemplated at the time, but is certainly not ideal from my perspective. The vehicle has been ideal for us to be able to not be worried about redemptions when you go through distressed markets like March of 2020 has been hugely, hugely beneficial. You know, we had every single cent in this portfolio invested in stocks at the end of March 2020. If we were sitting there at that point in time, meeting client redemptions and having to sell those stocks and having to hold more cash because we knew there were more redemptions coming. I honestly think it could have potentially been a terminal event for the vehicle where we would have had to have locked it up and give people their money back over time. And that's not an outcome the clients want. It's not an outcome that we want. So I think the structure is the right structure for the vehicle, but we're seeing at the moment there are downsides to it, in terms of they can trade at discounts and premiums, then net asset value.

Martin Dinh Just a quick one on that point about the structure, would you say that the structure was fundamental in terms of how you've been able to deliver your returns, say, over the last 12 months?

Steve Johnson Absolutely. I mean, you can't put a number on it. You can't put a number on it. But I honestly think it's tens of percents not, you know, a few, not half a percent or a percent or something like that. I think it's been instrumental in us adding opportunities at the bottom of the market. But more importantly, when I look back at the stocks that performed outstandingly well for us over the past 12 months, most of them were the ones that were beaten up most badly in March and even prior to that. We've had a pretty big, I'd call it a value bare market here leading up to COVID, and then it got worse as a lot of other funds were going through redemptions. So it's not just the stocks that we bought, but it was our ability to hang onto those opportunities that were trading at crazy, crazy prices at the bottom that has led to the performance that we've had over the past 18 months.

Martin Dinh So back on the topic of, you know, you establishing the fund back in 2009 and I've heard in interviews, you've called it your baby. I was wondering, though, has your investment philosophy changed since that time?

Steve Johnson I wouldn't say the philosophy has changed, but I would say I've learnt a lot and I would say that running a fund that's now $220 million is very, very different from running one that's 10, which we raised $10 million when we first launched the fund, which I thought was great and was a big vote of trust in me because I wasn't... I'd come from that Intelligent Investor background. I'd worked at Macquarie prior to that, doing corporate finance and project finance stuff, so I didn't have direct funds management experience. So, you know, for people to hand me $10 million and say we trust you and have faith in you was a really big step for me. I think when you're that size, it's 90 percent stock picking and it's 10 per cent portfolio management. As in, you just need to come up with good ideas and you can invest in most of them, and if you make a mistake, you can get out of that investment pretty easily and pretty quickly because $500,000 is a five per cent portfolio weighting at that size fund. I think as the business grew, as we started a new fund that spread our resources more thinly and as we've just taken on more money, that idea generation process and the types of stocks that we want to buy, the philosophy around that hasn't changed. But the way that we put that together in a portfolio has changed quite dramatically. I think we've learnt to think a lot more about portfolio liquidity, a lot more about risk management, be a lot more selective about us taking on illiquidity because the size that we're at now, some of these stocks are impossible to get out of if it goes wrong. So you really want to sit there and say, well, if I'm going to take on this illiquidity, this inability to sell, then I want to really make sure I'm doing that in the right sort of business. So I think that's number one. I would say the other thing, I think just reading through your run sheet, we might get to mistakes a bit later, but the other thing that's been really, really important for me is to recognise that the whole Foraging philosophy, to some extent that involves being contrarian. It works really, really well at the right point in time. There are times when the market is offering you extraordinary returns for going against the crowd, and there are other times when the crowd is getting most things mostly right. I think it's been an important part of our evolution to recognise that we don't need to be aggressively contrarian all of the time. We need to recognise when the market environment is right for that style of investing.

Martin Dinh Yeah, I'm sure we'll touch upon that later. I did want to maybe dive into a little bit deeper on one of the points you mentioned about the difference between stock picking and running a funds management business. So are you saying that when you're stock picking, you can have saved, for example, 50 of the best ideas, but if they don't work together when you run a big fund, it may not be the best way to run a strategy. Does that make sense?

Steve Johnson Yeah. Well, I think there's… I mean, obviously the stock picking is still a very, very important part of it. If you're not finding the right opportunities and you're not buying them at the right price then you're not going to make money overall. But I think the portfolio management piece is, well, how do I put that… Let's say, you've identified 50 that are potential candidates and you think 30 of those are sensibly priced or even cheap and cheap to varying degrees at any point in time, how do you put those 30 stocks together in the best possible way to optimise your returns and to minimise the amount of risk that you take on to get those returns? That involves thinking a lot more deeply about things that are not necessarily just the value of that particular security that you're looking at. It's the correlation between different securities, you know, if you got 10 different things in your portfolios that are all exposed to the same end factor, then maybe you're having a much, much bigger bet than you would have thought you were having. It's thinking about the future opportunities that you might have down the track, and that's been one of the really big things for me to recognise about liquidity. It's not just, is this particular investment going to work out? But am I going to be able to take advantage of the opportunities down the track that at certain points in time, I know that they're going to be better than the opportunity set that's in front of me today. So how do I invest in the market and participate in the market's returns, but keep that flexibility to be really aggressive when the market's giving me opportunities to do things that are going to generate 30 and 40 percent returns rather than 10s? So I think, you know, putting a lot of work and effort into how you put that together. And I think that's even true of individuals' portfolios as they get older as well. I think when you're in your 20s and you're picking stocks, you've got so much future income and future savings that you're going to do that you can actually afford to lose. If you're 25 years old and you've saved yourself $10,000, you can buy two stocks, and if they both go wrong, you lost $10,000, but you're going to save another $500,000 or million over your life. So that is not a terminal event for you. If you're 60 years old and you don't have any more savings, you're running all of your life's savings to live off of the rest of your life. You can't afford to make that same mistake at that point in life. So I think it's true for individuals as well that, the bigger your portfolio gets, the later you get in life, the more you need to start thinking about some of these risk management principles across the portfolio.

Martin Dinh So, Steve, when you look at the list of companies in the Forager Australian Shares Fund portfolio, can you think of a company or two that really encapsulates that Forager investment philosophy? I think what I'm really trying to uncover is that if I were to speak to say, one of your biggest shareholders and ask them what is a Forager stock? What stock do you think they would think of first?

Steve Johnson I think that would depend on which client you spoke to, for sure. Let me pick a couple in the current portfolio that display what we're trying to do, what we have done really, really well historically and then I guess the nuance around that that we think we need to do a little bit differently in a different stock.

So I would say Enero Group is a stock that a lot of our clients would be very familiar with. I think we've done very well out of over the past six or seven years. It was actually a mistake when we first bought it, but we have owned that business now for 10 years. And I think the difference there is that there's been a transformation going on in that business for the past five years that people had not picked up on at all. It was still being priced as if it was a business that was declining into perpetuity, and there was a CEO who had owned one of the businesses that got bought by Enero that sort of got left in the CEO's chair and had to fix up all of the problems. His name's Matt Melhuish and he did a fantastic job of turning that business around. And I think it's still a story today, the share prices are up a long way, but you have a business within that business that I think is worth dramatically higher multiples than... It's a marketing services business, so they own a bunch of marketing agencies. They're doing work for the Australian government now in their BMF business here in Australia, they own a large tech PR company. Everyone knows these businesses around the world and if you look at Enero, it trades at a lower multiple than most of the global players, and maybe there's a good reason for that because it's small. But they also own this ad tech business. So it's more of a platform in the online world for serving Google Shopping ads up onto websites for mostly newspaper publications. So these old newspapers that have now got their own website, this company is running Google ads on their site for them. They only employ 16 or 17 people. The business is making $10 million a year, and it's growing very, very, very quickly. So unlike a normal marketing agency where to grow, you need to add more people and it's just a pure, you know, we get $100 of revenue, we pay 60 to the staff and we try and keep 20 at the end of the day. This is a business that as it's grown, they haven't had to add any cost to the business at all, and you've got 80 per cent margins that are dropping straight through to the bottom line. So I think that's a really good example of trying to identify value in a company that is not necessarily by the market. And really our biggest successes have not been we bought a dollar for 50 cents, but it's been recognising some of these businesses that can be perceived very, very differently from the market at a point in time. So if this tech side of Enero keeps growing, it's already 40 per cent of their earnings. If it becomes 60 and 70 per cent of their earnings, all of a sudden people start looking at this and go, oh, this is an ad tech business, not a marketing services business, and how do we value that? We value that very, very differently. So I think it's actually quite a good business that I expect to grow over time that is being valued and treated like it's a shrinking business that's going to shrink into oblivion. So I think that's a, you know, a good example of what we try and do. And then I think, we own the two fintech lenders here on the ASX, Wisr and Plenti, and I think most people would if you asked our client base, say small fintech stocks are not what Forager does. But I think again, they're two really good examples of people missing what's going on in that part of the world. If you think back six or seven years ago, people were all talking about peer to peer lending, now all these people are not getting any money on their deposits, and all of these people are paying sky high rates for personal loans. Why don't we build this platform that just connects the lender straight to the borrower and we'll cut out the banks in the middle? And you look at all of these fintech players now and you say, well, who's providing the funding? And it's coming mostly from the banking sector. So it hasn't really worked that peer to peer piece of it. The reality is that the banks, because of their size, they have a very low cost of capital, they're able to borrow money very cheaply and they're a very good source of capital for these fintechs. What they are doing is they're acquiring customers, they're doing the front end processing much more efficiently than the banks had ever done it. So you've now got this very encouraging environment I think, where the banks are saying, you know what, we're happy to do the lending here, we'll provide the money, you guys go and find the clients, you deal with all of the regulatory side of things, you make sure that we're attracting the right sort of loans. We're happy to earn two percent margins here because we don't have to put much equity up, we don't have to provide a lot of capital and the fintech guys are writing very significant amounts of loans now and growing very quickly. So I think those businesses are examples of OK, they're not currently profitable, although Plenti was out this morning saying they expect to be profitable this quarter, which is the most people were expecting. But it's pretty easy for us to model forward. Okay, you just keep writing this number of loans for the next three years. As that loan book matures, they're going to be making substantial amounts of profit. And I think today's share price is going to look very cheap. So they're an example I think of a type of idea that we're investing on the basis that the future is or that even I'd say the best way of thinking about it is the way that they're accounting for those customers that they're acquiring at the moment is not adequately valuing what they're doing, it's actually a profitable business where they're acquiring very profitable customers right now. They're just not booking that profit immediately. They're booking it over five years as that person repays the loan that they've been given. So the opportunity there is, OK, these businesses are doing very well. You're just not seeing it in the accounting yet. So I think they're a couple of examples of two very different stocks in the portfolio. Most people would probably be familiar with us historically, though, from our association with RHG, the old Rams home loans, that was a mortgage book that was in run off that at one point was trading at four cents and paid a dollar fifty in fully franked dividends over the next five years or so and shrunk almost down to zero. It ended up getting bought, but it was a fraction of the size that it was originally. But yeah, that was the stock I think most of our clients in the early days had made money from my recommendation on that RHG at Intelligent Investor and when we started the fund, was on the back of some very significant profits that had come from that and saying, look, we're happy for you to manage a bit of this for us. So I think those, you know, some of those net asset plays, quirky accounting, those sorts of things, have historically been a bit of bread and butter for us. But even within that, we're trying to find businesses that are going to grow and pay dividends over time, but are under appreciated by the market.

Martin Dinh So when you've got these stocks, for example, you have Wisr, you have your Plenti. When do you think is the right time to sell? How do you factor that in?

Steve Johnson This is probably been another evolution for me over the past 10 years. I've really tried to take 'buy and sell' out of the lingo at Forager. What is the right weighting for this stock at today's price? Is the question that I want to ask, and the buy or sell is then a subsequent decision to what I think the right weighting is. So we very, very rarely go from, you know, we bought this stock, it went up three times and then we put it all on two days. We would typically have a weighting on the day that we buy it, and that's based on the information that we have at that point in time and we're constantly trying to update that valuation. So I think one of the big mistakes people make is you buy a stock and it goes up 20 percent and you think, okay, it's up 20 percent, therefore I'm not going to buy any more of it. You only buy when it goes down because you think it's cheap and you only sell when it goes up. And this is quite numerical for us now. What is the value of this stock today and what is the right weighting based on the risk and the price that it's trading at and the other benefits it can bring to the portfolio? And often to get something right, you know, we might start with a two per cent weighting in a stock. We get some information, say with Plenti this morning putting out an ASX announcement, we're going to be profitable sooner than we'd expected, the loan growth is very good despite COVID share price. I haven't even looked at, share price is probably up since the market opened. It's really important not to get scared away by that share price rise, may be the right weighting today for us is three or four percent, and it's the share price has only gone up 10 percent cent, our weighting has gone from two to 2.2, we still want to add to that and make it 3. And then the reverse is really true on the selling side of things, it's not we wake up and today the stock is a sell unless something has gone wrong. You know, if we get a piece of information that says your thesis is wrong, the weighting is now zero immediately, we want to exit the stock, that can happen and does happen. But generally it's more of a gradual process that the share price just keeps going up and we keep taking money off the table. So I talked about Enero earlier, that share price has gone from a dollar to $3 over the past couple of years. It was a... I think it was a six per cent portfolio weighting for us at a dollar. Now if you think it's gone up threefold, but today's weighting is about two, two and a half per. We've done a lot of selling over the subsequent three years, but I still think it's quite a good idea that it's going to do okay from here. It's just that at today's risk and reward and price, it justifies 2 percent weighting, whereas at dollar it justified a six per cent weighting. And at some point, if the share price keeps going up, it doesn't justify a weighting at all, and that's the point at which we're zero. The other reason that might happen is something else becomes dramatically cheaper, or the whole market becomes dramatically cheaper. And you say okay relative to everything else, I don't want this in the portfolio anymore. I really think that language, because it makes it hard, it makes it really hard, I think, to make the right decision if you've got the language in your head around a buy or sell. Sometimes you're weighting is just too high. Even if the stock is a great business and it's going wonderfully well, you're sitting there and the weighting has crept up to 10 or 11 per cent and you're saying, I don't want to sell this stock because I think it's a great investment. I think that language can get really dangerous and you know, for me, I don't think there's ever been anything that was risk free. So you really need to think about mitigating risk. If you thought five per cent was the right weighting when the share price was half, then why is 10 the right weighting if the value today is not as attractive as it was a year ago.

Martin Dinh So, Steve, we've covered a bit about what goes behind the scenes when it comes to selecting stocks for Forager. So now I wanted to talk a bit more about the journey, and I think one of the best places to start is to talk about some of the returns that you've had for the Australian Forager Shares Fund over the last 12 months. According to the most recent ASX Investment Products Report, the Fund delivered a return of over 60 per cent over the last 12 months, and it did rank in the top 20 performing listed investment companies and trusts on the ASX. And I guess when I saw these returns, I thought to myself, how did the team at Forager do this? Because I'm sure that there's not that many fund managers that have been able to do that throughout the entire lifetime. So I guess my question to you Steve is, how did you do this and what sort of factors do you think helped contribute to the strong performance of the fund over the last 12 months?

Steve Johnson It's really important when looking at any fund managers returns not to overweight what's happened recently, and I say that after a really good year and I say it after a bad year as well. So, you know, the 60 per cent return over the past 12 months for us is less relevant than the longer term returns. We needed it, we'd had a couple of difficult years prior to that, and we've put a lot of work into making sure this portfolio was set up to perform very well. So the year was fantastic. It was the result of a lot of hard work, but I think it's far more important for people to focus on the five for us since inception funds been around for 12 years, it's returned 12 and a half percent per annum after all fees over that 12 year period. And for me, that's great. It's four percent a year more than the index. It adds up to a lot of outperformance. It's still something I think we can keep working on over time. Someone asked me when I started what my personal expectations were around what this fund could do, and I think we should be targeting as a team 15 per cent per annum returns. Then we get paid fees, you know, a percent and a half is going to come off that. So, 13 and a half would be a really good outcome for us, sort of meeting my high expectations. We've managed twelve and a half over that 12 year period and I think we can do a few things a bit better over time as well. I think it's really important, I think people hear 12 and a half and the index has done eight and a half and you go, okay, that's outperformance, it's good. It actually adds up to a lot of money. Someone who invested $10,000 with us back at the start, that investment's now worth more than $40,000. And if you had it in the index, it's worth 26. So the gap of a four per cent compound difference adds up over a long period of time. OK, so with that as a very long caveat, the past 12 months, I think there's been some important changes to our portfolio that have made a big difference. We had March of 2020 and the subsequent six months where markets were extremely volatile. That has always been an environment in which we've performed very, very well. Our clients expect that of us. I think we're psychologically wired to perform well in those types of markets, and that's something that when I'm managing a team, they're the days when I walk into the office excited and say to people, this is where we really add a lot of value. So the market environment has been very friendly. And then most importantly, from my perspective, I've put a huge amount of effort into getting the right team in place at Forager. When we kicked off, it was a small fund. It was me and we had another analyst, Matt Ryan, working with us at the time, so two people. I had all of my own money invested in the fund, so the alignment was perfect. As we have grown, we've had to work really hard on making this business and funds management culture be more than one person. So how do we take what I was doing well in my head, turn it into a process and a philosophy that we can bring smart, driven people into the business and get them to do that well. Get them to do it better in a lot of cases and incentivise them in a way that means that they can have the career that they want working for Forager. And honestly, I think that's been the hardest challenge we've ever had as a business. It's been the hardest challenge I've ever had as an individual because it's not the part that comes naturally to you. I like picking stocks and analysing companies, but the honest truth is for us to be successful over the long term that people side of what I do is super important. We brought on a CEO five years ago that's been instrumental in helping me with that. We've got a board member who's a shareholder in the company as well with a lot of experience managing teams at Macquarie, and he's worked really hard with me on trying to get some of those things right, and we've had to make some structural changes to the products to try and get that alignment piece of it right as well. So when I was the only person and I've got all of my money invested in the funds, performance fees are not that relevant. When we set the international fund up I said, well, I put all my money in it, and if we do well, then I make lots of money, and if we don't, then I don't. But then you try and attract someone to come and work for our business in a very competitive funds management industry and that person says, well, how are you going to pay me bonuses? And if I do really well and I deliver massive outperformance for your international fund, how do I get paid? And we actually had to go back and change the fee structure on that international fund to say we need a performance fee here because we need a team of people, not just one person doing a good job and we need to attract some talented people. And that's been for that fund instrumental in some sensational returns over the past couple of years, largely unassociated with my stock picking skills. We've brought people into the business that have done a wonderful job of finding new opportunities and putting those into the portfolio. For me, it's something that may be getting out of the road was something I should have done a long time ago, but it's actually something I'm really, really proud of, that those people are doing well in our organisation because I don't see it in a lot of funds management companies. I think it's largely a fairly dysfunctional industry of people that are great stock pickers or great individual fund managers that struggle to grow their business into something that thrives independently of them.

Martin Dinh So Steve, we've talked a lot about the successes and you've kind of touched on, you know, you've had a really tough, I think, 17, 18 and 19, where you've underperformed the market. I think you may have touched on some of the reasons why, but I think what I really wanted to know was, what are some of the lessons that you've learnt from those issues? And if you wanted to dive deeper into what you think went wrong, feel free to do that as well. But I think we are also curious to learn what are some of those lessons that you learnt?

Steve Johnson Yeah, I mean, you touched on our one year return a moment ago, and if you go and look at the five year return for our Australian fund, it's still, not dramatically, but it's still a little bit behind the market over a five year period. So if you think about how good the past 18 months has been, that tells you that some things went wrong in the years prior to that. I feel like as a business, we've done a lot of reflecting about it. We've talked a lot about the mistakes. I think we've improved a lot of things. It really is time, and it has been for some time now, to move on with and get on with making money for our clients, but it is really important to reflect on that period. I think there were a few external things and then one really big internal thing that's been a big lesson and I think a big change in our business. I think externally it has been a very difficult decade really for our style of investing, and I don't just mean, you know, the deep value end of the spectrum. I think even just buying better quality businesses that are paying you dividends, that whole strategy was out of favour for a long period of time and that 17 to 19, well, I think right through until the start of 2020, culminating in the COVID crash of March, it became self-perpetuating. So the performance was bad. Money started flowing out. We had three or four competitors go out of business over that period of time. Those competitors own all of the same stocks that you own, typically, they're selling them. You know, your performance gets worse because people are selling stocks. They keep getting cheaper than there's more redemptions, and it really got quite extreme, and then COVID happened, and there basically wasn't a market. So I think the set up was a difficult external environment. I think internally we could talk about some specific stocks if you wanted to...

Martin Dinh Feel free to do so. Yeah, if you want to go through a specific stock, that would be OK.

Steve Johnson Well, I think the big picture is being aggressively contrarian all of the time. We actually had a couple of difficult years when I first started the fund. 2010 through 2012, we were a bit behind the index over the first two years and I remember writing a blog post threatening to sack myself if things didn't improve fairly soon. Then from, must have been six years. We had six years of very significant outperformance almost every year, and we were up in years where the market was down and when the market was up, we were up even more and it was a very strong period for us. That was largely through contrarian investing businesses like Jumbo Interactive, which is now a bit of a market darling, but was trading at 90 cents. It had a third of its market capitalisation in cash at that point in time and had a very, very profitable Australian lotteries business that people weren't taking any notice of. Now that was wonderful for our service stream, wonderful for us. And then, I think that going against the crowd and doing really well out of it created a culture that that's what we do well and we need to do it all the time. And if you'd said to me back then, what is your investment philosophy? I would have said, we're looking where other people are not looking and we're contrarian. And I would say the biggest lesson was 2016 was a good year, 2017 and 18, I actually wrote a blog piece for Livewire Markets saying, here are 10 big blue chip companies that are going to do perfectly well for you over the next couple of years, you can earn 8 to 10 percent returns from these stocks. They're perfectly sensibly priced and in a market that is not doing a lot of irrational behaviour, that's really where you should be looking, and we weren't doing that with our own portfolio. I was still out there looking for significant mispricing all of the time, and it led us into a few businesses that, you know, we made a fairly convoluted case for them being extremely cheap at a point in time and it turned out that they were flawed businesses and they were cheap for a very good reason. I think in some market environments and we're in one of these at the moment, I think in some market environments, everyone is picking over everything and they're doing a pretty good job of it. And if there's anything out there that looks like it's screamingly cheap, the most likely explanation is that you're getting something wrong rather than the market is getting something wrong. We owned freedom insurance, which got caught up in the Royal Commission into financial services, and that business actually ended up getting shut down. It had a balance sheet that we thought had 40 or 50 million dollars' worth of net assets on it or did had 40 or 50 million dollars' worth of net assets on it, that completely evaporated. So that individual stock had a significant impact on the fund. But I think more widely when I look back to that portfolio, it was largely just trying to be contrarian at a point when it didn't make sense to do so.

Martin Dinh Would you say that instead of being contrarian all the time, you're trying to also run a balanced portfolio more frequently nowadays? And maybe just picking those opportunities when they arise? Is that kind of like what you're trying to do right now with your portfolios?

Steve Johnson Yeah, absolutely right. I just put the finishing touches to our latest quarterly report actually. I've been playing quite a bit of chess in lockdown, and I'm not a very good chess player. I haven't played game in 20.

Martin Dinh Queen's Gambit?

Steve Johnson Yeah, Queen's Gambit got me interested again. I haven't played much in 20 years. I'm just home on my own, so I restarted the chess.com account, and the tools these days are just incredible. It's so much fun just to sit there and learn chess through the computer because the teaching programs are incredible. Now you can go back after a game and go through every single move and the computer will tell you what the best move was, whether your move was any good, whether it was a blunder or whether it was a mistake. And you know, I had a pretty good understanding of opening games in chess. There's probably 10 variations that you can learn and I had a pretty good understanding of some of the basic ways of, you know, taking pieces then attacking, but some of the computer generated moves in the middle of the chess game were mind boggling to me, you know, it was just move a porn piece one square down the board that doesn't attack anything or move one of your key pieces backwards. It really got me thinking about the investment world in a similar way. I think there are times and environments when the setup is right to be contrarian, and it's usually when everyone is being very extreme about the way the world is going to go. It's all going to fall apart. You know, this time is different. You're hearing all of that language, you're seeing the headlines on the newspaper. That's the trigger for me to say, OK, this is the time to be aggressively, aggressively contrarian. When the market's hitting all-time highs. You know, people are talking about how interest rates are going to stay low forever, and there's so much inflows into equity markets. The environment is just one where people are not going to misprice a lot of securities dramatically. So for me, it's all about being, OK, this is a middle game of the stock market here. I want to be invested in equity markets over long periods of time. For me, it's not go and put all of your money in cash because the opportunity cost of doing that is very, very high. I've seen more money lost doing that than I've ever seen made, you know, participating in the market crashes when they come along. So I want to be invested in equities, but I think you can put together a really sensible portfolio of stocks out there at the moment without being crazily, aggressively contrarian, and you can make a perfectly sensible seven or eight percent a year. And when the time comes, when people do things that are crazy again, we'll be ready and able to take advantage of that and it will happen, it happens time and time again. So, you know, we still own... There's plenty of small cap stocks in our portfolio, businesses that I think are going to do really well over the next 10 years and provide us with perfectly adequate returns. But those weightings are typically two and three per cent in our portfolio at the moment. I want them to be sixes and sevens at the right point in time. But that will be when people are getting them very, very wrong rather than, you know, this is a nice business at an attractive price. I want to save those big portfolio weightings for nice businesses at extremely attractive prices.

Martin Dinh So Steve, moving along, we've talked a bit about some of the reasons why you've structured the fund as a listed investment trust. It was because you held a proportion of your portfolio in illiquid stocks. So, you know, sometimes during times of distress, it could be hard to liquidate those positions and you want to be able to also have a fixed amount of capital to make sure that when the opportunity arises, you can invest in those bargains in the stock market. However, one of the main features of listed investment companies and trusts, just noting that your particular fund is structured as a trust, is that, you know, we've touched on that point, it can trade at a premium or discount to its NTA. So at present, I've looked at some of the data. It is quite common for the structure to trade at a discount to its NTA, with around 75 per cent of listed investment companies and trusts trading at a discount. Now really just to provide a bit of context, the Australian Forager Shares Fund, it has been trading at a persistent discount to its NTA since, I think, around early 2018, and this is despite the strong performance that you just had over the last 12 months. I don't know about you, about Forager, but one of the most common questions that we get from investors when it comes to listed investment companies and trusts is why do NTAs occur so persistently and what can be done to fix it? So I guess my question to you, Steve, is why do you think the fund has been trading at a persistent discount over the last few years? And what do you think is the way forward to close this discount to NTA?

Steve Johnson Great question. To be honest with you, I'm mildly perplexed. I think in terms of interesting things that you can do out there in the market at the moment as an investor, buying funds with fund managers that you like and think are going to do well over a long period of time at 10 and 15 per cent discount is about as simple, but I think as effective as you're going to get. You know, if we can do 12 and a half percent per annum on the net asset value from here and you pay a 15 per cent discount to that, you can lift that return from 12 and a half to 15, even if that gap never closes, right. You just sit there and collect your returns over the next 20 years, you're going to earn 15 per cent more return than someone who paid full price for it. So I think if I were retired and just wanted to live life easily, I'd just sit there and invest in the LIC and LIT market, buy these things at discounts and sell them at premiums because these waves seem to come and go, and I don't think anyone fully understands why the extremities that occur out there do occur. But it's not acceptable for me to sit here and say, you know, the industry or the sector is going through one of those waves where it trades at a discount. We have always not put up with that as an excuse. I think we want to do things with our vehicle that make it more attractive for people to invest in. I think ultimately those steps need to get more and more extreme to try and bridge the gap if the first steps that we take don't work. So number one for us has been performance and rectifying performance. You're right that that hasn't made an impact despite being very good over the past 18 months. I still think another 6 to 12 months is going to put that period of bad performance further and further behind us. The second, and I think the really significant one for us is, you touched on this, but it's a listed investment trust. So ultimately, those returns that we make do come out to investors as distributions. Those distributions have been very low for the past few years because the returns were low prior. We will realise a significant, we already have realised a significant amount of profit this financial year. So those distributions are going to come back and they're going to be very significant, whatever the returns are significant. So I'll be very interested to see how that resumption of distributions impacts on the market price. And then I think if those two things don't work, then your only choice is to start nudging yourself away from what is, we think, the perfect vehicle for our investment style. So providing other forms of liquidity or doing things that are more extreme around letting people access their investment at or near net asset value. Now that has to be a step towards, the only way you can do that is to provide liquidity from the fund. So it's a step towards, back towards, being more of an open ended vehicle. But there are people out there trying interesting things around various degrees of frequency around doing that. We will think about some of those more extreme measures I think if this time next year, that discount is still persisting, but the plan over the next 12 months is to really consolidate that good performance that we've had and then see what impact it has when that performance starts turning up as distributions to people.

Martin Dinh I think just on that point as well, I did a podcast with Ian and we talked a bit about this, and the discount could also provide that opportunity to buy the price of the particular fund at a price that's below the value of the underlying assets. In particular if Forager, if you are able to deliver those returns in the medium to long term, then that could be advantageous for those investors.

Steve Johnson I think all of the people who think like that though, in terms of the persistent discount of the vehicle. I've been buying units in our own fund over the past six months, and when I go on the market to buy, I'm putting an order in at a 14, 14 and a half percent discount to net asset value. I've been hit on those trades and I'm trying to buy it as cheap as I can. I think all of the people who think that way are also doing the same thing. And while ever they can sit there and buy it at a 13 or 14 percent discount, they're not going to push the price to a five percent discount. So I think we've got a really strong core of those types of investors, I think, and I'm one myself that are willing to keep investing in the vehicle at a big discount to NTA. I think to bridge the gap, though, you really need to start attracting people that are less whingey about the price that they want to pay, if that makes any sense. I think, you know, once you start getting distribution, it really needs to become something of this is the only fund that we run in Australian equities. So a lot of other fund managers, you can buy their open ended fund as an alternative to the listed investment company. We don't have that structure, this is it. So I think if we keep delivering performance and people say, well, the only way I can get access to that is to buy this vehicle on market, and at some point, I think the selling at a big discount dries up as well, where people say, well, why would I sell this at such a large discount to NGA if the returns are good and the distributions are coming out to me? And again, I think that distribution for someone, and we've got clients that have been with this for

12 years now, someone might have invested when I was 60 years old, they're 72, they start getting to a point in life where the income becomes important to them, instead of having to sell a few units every year if they're getting that return through distribution, then I think that will hopefully enable some of those people to stay with us for longer as well.

Martin Dinh So we've talked a lot about the past and the present. So the only question left to ask you is about the future. You know, the future is a broad question, so I wanted to nail it down just to inflation, which I think is an area that many investors are closely following. So my question to you, Steve, is what do you think will be the impact of rising inflation on your portfolio? And are there any areas of the market that you're looking at or avoiding in response to the prospect of rising inflation?

Steve Johnson Again, I've talked a bit about this in our quarterly report out this quarter. I think it's an issue that we've been thinking a lot about, we've been talking about. It's very, very exposed to the too hard basket for me. I don't think the market again is ignoring the issue. I think there's lots of stocks that are being priced like inflation is a risk. I look at it and I say it is a massive risk. And I think, you know, to the extent interest rates have to go up, it's a potential time bomb. For equities and a whole heap of other asset classes. But if you're buying 30 year German government bonds at negative yields and interest rates are going to go up, then it's going to be catastrophic in terms of its impact on a lot of those asset prices and, you know, I think equities trading at a higher multiple now because interest rates are so low, so it had an impact on equities, I do think it's significantly less than property prices and bonds and things like that. I don't have a strong view around whether this is temporary. It's quite clear that we're seeing lots of inflation out there. Every company I talk to is trying to navigate problems with supply chains, with prices going up, chip shortages, there's all sorts of issues out there. I've seen really coherent logical arguments for why it's temporary and passing and why the demographic savings, all of the things that have caused inflation to be very low for a long time have not gone away. I've seen coherent arguments for why that piece is going to win out, and I've seen very coherent arguments for, OK, now this is turning up in wage inflation, which had been the missing piece of the equation. You've got Walmart announcing a couple of weeks ago that they're paying $18 an hour to entry level employees. That was $7.50 back in 2010. I think that's probably a good thing for wealth inequality in the world. But you know, there are, I think as it starts becoming embedded in people's expectations and in wages, then it's an issue that the central banks are going to be really forced to start thinking a lot more about. I'm trying to balance the portfolio around both sides of that argument and trying to not be sideswiped by that happening. So let's make sure that our portfolio is not going to blow up in an environment where inflation is higher than people are expecting. We've got some stocks in there that are intentionally there to provide some protection against that. I think the banking sector globally is one that is priced for interest rates to stay low and margins to stay low forever. You can buy Lloyds, the UK's biggest bank, basically the equivalent of CBA here, for one times NTA, and I think it's something like six or seven times next year's earnings. And if the government or if the banking authorities let them, they should pay most of that out of dividends and if interest rates go up they're beneficiaries of that. So we're trying to balance the portfolio out with some of that stuff. We generally avoid, I call them long duration assets, but businesses that are priced very, very highly because interest rates are low, people are saying, well, that profit that they're going to make 20 or 30 years down the track is worth a lot of money to me today. You've seen that small cap end the market, be very, very sensitive to bond yields. We don't have a huge amount of exposure to that, particularly in our Australian fund. So we're trying to, you know, not increase that exposure, certainly because of this risk. But I think it's a fiendishly difficult problem that we don't need to necessarily solve it to do well. I think there's going to be easier problems to solve than that over time.

Martin Dinh Great response, Steve. So increase allocation to financials. Okay, I'll do that for inflation.

Well, they're cheap anyway. I think you'll do just fine if the inflation argument doesn't take hold, but you'll probably do exceptionally well in an environment where it does.

Martin Dinh So, Steve, just before we wrap it up, you know, for investors that want to, I guess, keep up to date with your work as well as Forager's work, where can they find you?

Steve Johnson Our Website, foragerfunds.com and you can register there to receive our quarterly reports and blog posts and things. I'm on Twitter @foragersteve and Forager Fund is also on Twitter @foragerfunds. Facebook, LinkedIn, every social media known to man, you can find us on all of those, but I'd say for me personally, I'm more active on Twitter than anywhere else, so you can follow me on Twitter. And if you want to receive our communications, jumping on the website, registering your email address is the best way to go about it.

Martin Dinh And also my final comment here is to our listeners. Also, check out Steve's most recent interview on Live Wire, a lot of good content, lessons and takeaways there. So, Steve, that wraps up this month's episode. It's been a great, you know, it's been a long conversation, but time definitely flew. You've mentioned some very interesting stories. And also it's great to just learn about, you know, what goes on in your mind when it comes to selecting stocks, but also looking at the ups and downs as well, because I think that gives you that human element and that you're not immortal. Hopefully we can catch up again down the road and looking forward to hearing how the fund is doing in 12 months.

Steve Johnson Appreciate it, Martin, and thanks everyone for listening in.

Martin Dinh Well, I hope you enjoyed my chat with Steve and learnt a bit about Forager's unique investment philosophy of finding value, often in areas where investors aren't looking at. In next month's episode, I'll be joined by Alex Pollock, CIO and one of the founders at Loftus Peak, as we hear about how they find companies that are driving or will be the beneficiaries of the accelerating pace of change across global industries. Until then, stay safe and we'll see you next month.

CTA This November, Investor Day brings you expert insights and ideas in an entirely virtual, on-demand format. Visit the ASX website to hear from industry leaders about investment strategies at your own pace in your own time.